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Deductibility of Reserves for Workers' Compensation Losses by Self-Insured Employers

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Notes

DEDUCTIBILITY OF RESERVES FOR WORKERS' COMPENSATION LOSSES BY SELF-INSURED EMPLOYERS

Employers who self-insure workers' compensation risks, typically for financial reporting purposes, establish reserves for anticipated expenses of such losses by charges against current income. The deductibility of these self-insurance reserves for federal income tax purposes is the focus of this Note. The author first examines the background, nature, and regulation of workers' compensation. Financial reporting requirements then are contrasted with tax accounting concepts regarding treatment of the reserves. Finally, the analysis concludes that self-insurance reserves should be deductible for federal income tax purposes when the objectives of tax accounting are not frustrated.

INTRODUCTION

MANY EMPLOYERS utilize self-insurance or a large risk retention to fund the ever increasing expenses[1] of liability for employment-related injury and disease. The heightened financial responsibility placed on employers by increasingly strict state workers' compensation statutes and its attendant insurance costs forces employers to retain the risk, or a great portion thereof, of insuring their employees.[2]

Sound accounting practice requires that employers who self-insure these workers' compensation risks establish an allowance or "reserve" for anticipated expenses of workers' compensation

1. *See generally* Treischmann & Levereth, *Answering the Question: To Self-Insure or Not to Self-Insure Workers' Comp Costs?*, 27 RISK MGMT. 39 (1980). "In 1973, workers' compensation accounted for 11.9 percent of total property-liability premiums, according to *Bests' Review*, Property Casualty Insurance Edition, June 1979. Since 1973, workers' compensation's relative share of all property-liability insurance premiums has increased. In 1978, premiums were over 12 billion dollars, and workers' compensation accounted for 15 percent of property-liability premiums." *Id.* An examination of the increased burden of workers' compensation as a percentage of payroll reveals that the cost was $0.89 per $100 of payroll in 1959. This amount increased to $0.96 in 1962 and $1.12 in 1975. By 1977, cost in terms of aggregate payrolls rose to $1.71 per $100 of payroll. This 1977 figure represents a 92.1% increase since 1959. *Id.*

2. A survey of Fortune's top 500 industrial corporations indicates that five out of six companies were self-insuring some portion of their corporate risk and most expected their percentage of self-risk assumption to increase. Fortune Market Research, *How Major Industrial Corporations View Property/Liability Insurance*, FORTUNE MARKET RESEARCH 21-23 (Oct. 1973).

losses growing out of current operations.[3] Such a reserve is typically established by charges against current income when management is reasonably certain that expenditures will be required that are not currently payable obligations and the amounts of these obligations can be fixed with precision or are reasonably estimable.[4] The federal income tax implications regarding these reserves become significant. The tax issue is that while payments to insurers for workers' compensation insurance premiums are fully deductible for federal income tax purposes regardless of employer losses,[5] reserves for contingent or accruable losses of self-insuring employers presumably do not become deductible until after the losses are payable,[6] despite their deductibility as they accrue for financial reporting purposes.[7] This disparity between the treatment of self-insurance reserves for financial reporting and federal income tax purposes is the focus of this Note.

The Note first explores the background, nature, and regulation of workers' compensation[8] and then assesses self-insurance as a mechanism for handling risks of loss due to employment-related injury and disease.[9] Additionally, financial reporting requirements are related to the self-insurance transaction and contrasted with the tax accounting concepts of this transaction.[10] The various rationales underlying the current Internal Revenue Service (the Service) position on the issue of "reserves" in general are ana-

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3. Although proper accounting terminology refers to these charges as "allowances," for purposes of this Note and for federal income tax purposes, all such provisions are referred to as "reserves."

4. Reserves also are employed as a valuation account measuring the decrease in value of an asset or balance sheet item. Examples of valuation account reserves are allowances for depreciation on buildings or equipment or a reserve for bad debts on receivables. I.R.C. §§ 167 and 166, respectively, specifically authorize these reserves as deductible expenses. A reserve also is employed as an appropriation of retained earnings. This appropriation is usually in accordance with legal or contractual requirements, such as a covenant requiring a bond sinking fund or the board of directors' authorization. Examples of the latter are appropriations for general loss contingencies, plant expansion, or possible inventory decline. This latter type of appropriation reserve generally does not involve allowable deductions. Appropriations for general loss contingencies do not satisfy the I.R.C. § 162 test of being an ascertainable, definite, and fixed liability to be deductible as an ordinary and necessary business expense. H. SIMONS, INTERMEDIATE ACCOUNTING 572-73 (6th ed. 1978).

5. I.R.C. § 162(a) (1976).

6. *See infra* text accompanying notes 63-69.

7. *See infra* text accompanying notes 34-62.

8. *See infra* text accompanying notes 20-33.

9. *See infra* text accompanying notes 55-62.

10. *See infra* text accompanying notes 33-54.

lyzed and then applied to self-insurance reserves.[11] The Note concludes that reserves for self-insurance should be deductible for federal income tax purposes in situations where the objectives of tax accounting are not frustrated. Such treatment conforms with financial reporting requirements and results in consistency between financial and tax accounting methods.

I. WORKERS' COMPENSATION

Both individuals and business enterprises are exposed to risks. A business enterprise, however, faces purely financial risk or exposure from employment-related disease and injury of employees.[12] It is essential that employers cope with these risks in the most financially expedient manner. That task is called "risk management."[13] Risk management is complicated by pervasive state regulation of workers' compensation liability and financial reporting requirements imposed by independent accountants and the Securities and Exchange Commission.[14]

A. *The Concepts of Risk Management and Risk Retention*

Risk management is essentially a threefold process: discovering the sources from which losses may arise; evaluating the impact of a possible loss on an organization; and selecting the most effective and efficient techniques to accommodate that risk.[15] Among the techniques for managing risk and reducing the uncertainty of

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11. *See infra* text accompanying notes 80-227.

12. Risk is generally defined as "uncertainty of loss." Classifying the risk is essential in determining methods of risk management. Although financial risks may be classified in several ways, two divisions are particularly useful for purposes of this Note: (1) the distinction between speculative and pure risks, and (2) the separation of fundamental and particular risks. Speculative risks provide the chance of gain or loss. Pure risks are taken with the prospect of only loss or no loss; there is no chance of profit or gain. Workers' compensation losses are pure risks. Fundamental risks arise from losses that are impersonal both in origin and consequence. The losses are not caused by individual action but generally originate in the economic, political, or social interdependency of society. Classic examples include war, inflation, unemployment, fads or changing customs, and obsolescence. Industrial accidents are an inevitable consequence of the industrial system. The rationale for workers' compensation is that the cost of this fundamental risk should be borne by the creators and beneficiaries of the industrial system. Particular risks arise from losses that originate in individual events; the impact is felt in localized consequences. These risks are essentially personal both in cause and in effect. *See generally* H. DENENBERG, R. EILERS, G. HOFFMAN, C. KLINE, J. MELONE & H. SNIDER, RISK AND INSURANCE 4-7 (1964) [hereinafter cited as RISK AND INSURANCE].

13. *See infra* text accompanying notes 15-19.

14. *See infra* text accompanying notes 20-62.

15. *See* RISK AND INSURANCE, *supra* note 12, at 67-68.

financial loss is risk retention by the enterprise. Risk retention consists of an integrated plan for internalizing costs associated with enterprise property or casualty losses. Through the plan, the enterprise makes provisions to bear the burden of the loss internally.[16]

Risk retention has become a popular technique of risk management because of corporate growth in terms of financial capacity to bear losses, the increasing cost of insurance—the traditional form of loss exposure protection[17]—and the increasing complexity of enterprise liability in dollar amount and types of liability exposure. The primary rationale justifying risk retention is that the costs of alternative methods of treatment may be greater than their value to the risk bearer. The risk also may be of such little significance that its adverse effects can be accepted readily when considered in conjunction with the amount and likelihood of loss, stability of cash flow, and composition of the firm's assets and liabilities.[18] Some risks, however, may not be susceptible to anything but risk retention treatment. Lack of an insurance market for the particular risk of the enterprise or the enterprise's past loss experience may prevent it from obtaining insurance.[19] Thus, employers seeking to accommodate workers' compensation risks in the most effective and efficient manner must internalize the costs of the risk of such losses. Pervasive state regulations regarding adequacy of funding for these risks complicate the enterprise's choice of risk retention and formulation of a risk retention plan.

B. *Regulation of Workers' Compensation*

Forty-seven states currently provide for compulsory coverage under workers' compensation laws[20] and nearly all employers in

16. Risk retention, a situation in which a plan or program has been established to meet the adverse financial results of a loss, but where no transfer of risk to another party is involved, is only one of four techniques of risk management. Others are: (1) increased knowledge of the risk bearer regarding existence of certain risks and methods of safeguarding against them; (2) prevention of loss and reduction of loss severity through precautionary measures; and (3) risk transfer through the mechanism of insurance for pure risks and through hedging or diversification for speculative risks. *Id.* at 8-10.

17. The traditional form of reduction of uncertainty of loss from risk was thought to be risk reduction through transfer and combination. I. PFEFFER, INSURANCE AND ECONOMIC THEORY 53-54 (1956).

18. *See* RISK AND INSURANCE, *supra* note 12, at 77-80.

19. *Id.*

20. Coverage is still elective in three states: South Carolina, New Jersey, and Texas. CHAMBER OF COMMERCE OF THE UNITED STATES, ANALYSIS OF WORKERS' COMPENSATION LAWS 3-4 (1981).

the United States are subject to some form of workers' compensation law.[21] State regulation of employer liability began around 1900 when negligence was used to determine liability for industrial accident costs. The applicable negligence rules were controlled by both state statute and common law. From 1911 to 1949, virtually all states adopted a shared strict liability system known as "workmen's compensation."[22] Under this system, an employer is obligated to pay employees a legislatively predetermined amount to compensate for employment-related injury or death, regardless of the cause of the accident.[23] The policy objectives of this system are prompt compensation of employees and reduction of litigation. Liability for an accident is imposed on the employer by operation of law once the employee shows that the accident or disease arose out of the course and scope of employment. Such statutes also fix amounts paid for wage replacement, medical reimbursement, death benefits, and permanent total disability compensation.[24] The only issues which may be litigated are whether the accident or disease arose in the course of employment and the existence and extent of disability.[25]

21. In 1977, 87.8% of all wage and salary employees were covered by workers' compensation laws. These figures represent an increase of 3.5% or 2.5 million more employees over 1976. Covered payrolls amounted to approximately $824 billion or 85.9% of total civilian wage and salary disbursements. *Id.* at viii.

22. Chelius, *Liability for Industrial Accidents: A Comparison of Negligence and Strict Liability Systems*, 5 J. LEGAL STUD. 293, 298 (1976). For a comparison of negligence and strict liability systems, see Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151 (1973); Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972).

23. Chelius, *supra* note 22, at 300.

24. The types of benefits fixed by law which the employer must pay are: (1) cash benefits for physical impairment and replacement for loss of income and earning capacity; (2) survivor benefits for fatal injuries; and (3) medical benefits for reimbursement of employee's medical expenses. The cash benefits for physical impairment and wage loss for permanent and total disability are fixed by a formula expressed as a percentage of wages. For temporary total disability, the same wage-replacement percentage as for permanent total disability is paid, but the dollar amount and the length of time benefits may be received are limited. For temporary partial disability, benefits are fixed by a formula based on lost wages or a percentage of total disability benefits. Benefits for permanent partial disability such as the loss of, or the loss of the use of, specific body members are considered scheduled injuries. Compensation for these injuries is established by law and subject to a maximum amount. Survivor benefits for fatal injuries are computed using a percentage of wages for a time period determined by existence of a spouse, number and ages of children, and a burial allowance. Medical benefits or medical expense reimbursement generally must be paid without limit as to time or amount. *See* CHAMBER OF COMMERCE OF THE UNITED STATES, ANALYSIS OF WORKERS' COMPENSATION LAWS 14-23 (1980).

25. Where an injury is caused by a third party's negligence, some states award the employee a cause of action against the negligent party. Since this award creates the possibility of the employee receiving both a workers' compensation *and* a tort-based recovery, some state statutes provide a safeguard against such a double recovery. *See, e.g.*, N.Y.

With a few exceptions, no federal laws directly control the administration or benefit levels of workers' compenstion claims among private, state, and municipal employers.[26] The Occupational Safety and Health Act of 1970 (OSHA),[27] however, has increased and standardized workers' compensation benefits. The Act created a National Commission on State Workmen's Compensation laws to determine whether state workers' compensation laws provided adequate, prompt, and equitable compensation for employment-related injury or death. The commission reported that state workers' compensation laws "in general are inadequate and inequitable."[28] The report, which made eighty-four recommendations, nineteen of which were declared essential,[29] resulted in several unsuccessful attempts to enact a uniform federal work-

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WORK. COMP. LAW § 29 (McKinney 1965 & Supp. 1981-1982). This safeguard is accomplished by reimbursing the employer from the proceeds of a third party recovery. Schreier, *No Fault and Its Relationship to Workmen's Compensation—The Lien Problem*, 50 N.Y. ST. B.J. 7 (1978).

26. Federal employees are covered under a workers' compensation statute similar to state statutes. The Federal Employees Compensation Act, 5 U.S.C. §§ 8101-8193 (1976 & Supp. III 1979). For a discussion of benefit computation and claims procedure under this Act, see Airolu, *Federal Compensation Procedures Today*, 10 FORUM 193 (1974).

A few statutes, though limited in scope, cover employees of private employers: (1) Federal Employers, Liability Act §§ 1, 2 (FELA), 45 U.S.C. § 51 (1976); (2) Longshoremen's and Harbor Workers' Compensation Act (LHWCA) §§ 1-22, 33 U.S.C. § 901-950 (1976 & Supp. III 1979); and (3) Jones Act, ch. 250, 41 Stat. 988 (1920) (codified in scattered sections of 46 U.S.C.). The FELA essentially covers railroad employees injured within the scope of employment. *See* Reed v. Pennsylvania R.R., 351 U.S. 502 (1956). The LHWCA covers any longshoreman or other person engaged in longshoring operations, and any harbor workers, including a shipbuilder and shipbreaker, for disability or death resulting from an injury occurring on navigable waters of the United States. *See* Stocker, *An Overview of the Longshoremen's and Harbor Workers' Compensation Act*, 12 FORUM 674 (1977). The Jones Act is designed to benefit employees on a vessel who aid in the vessel's navigation.

27. Pub. Law. No. 91-596, 84 Stat. 1590 (1970) (codified in scattered sections of 5, 15, 18, 29, 42, 49 U.S.C.).

28. NATIONAL COMMISSION ON STATE WORKMEN'S COMPENSATION LAWS, THE REPORT OF THE NATIONAL COMMISSION OF STATE WORKMEN'S COMPENSATION LAWS 119 (1972). "Adequate" is defined in this report as "delivering sufficient benefits and services to meet the objectives of the program." "Equitable" is defined as "delivering benefits and services fairly as judged by the program's consistency in providing equal benefits or services to workers in identical circumstances . . . ." *Id.* at 137.

29. These essential recommendations can be classified in the following seven broad categories:

1) All workmen's compensation laws should be compulsory.

2) Occupational and numerical exemptions to coverage should be abolished.

3) Occupational diseases should be fully-covered [sic] whenever work-related.

4) Medical and physical rehabilitation services should be unlimited as regards duration and monetary expense.

5) Claimants should be permitted a choice of location for filing claims whenever engaged in employment having multi-state contacts.

6) Weekly cash benefits in case of death, temporary, or permanent total disa-

ers' compensation statute.[30] OSHA's impact on private employers, however, is evidenced by approximately 100 amendments to state workers' compensation laws in 1976 and the drafting of 300 new laws in 1977.[31] Benefit amounts have doubled since 1972, and most benefit levels are tied to annual increases in national or state average weekly wages.[32]

Prompted by such federal action, states have sought vigorously to increase benefits and broaden the scope of employer liability under workers' compensation. Correspondingly, a dramatic increase in enterprise expenses has resulted, illustrating the urgent need for an efficient and effective plan for handling the increased risks of loss due to employment-related injury and disease. In addition to the increased liability resulting from recent legislation, employers are constrained further by consideration of proper financial accounting treatment of workers' compensation transactions.

C. *Financial Reporting Requirements for Workers' Compensation Losses*

Proper financial reporting requires that workers' compensation losses be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement No. 5.[33] The statement provides that an estimated loss from a loss contingency[34] shall be ac-

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bility, should be two-thirds of the worker's gross weekly wage, subject to the state's maximum . . . .

7) Weekly cash benefits should not be limited arbitrarily regarding duration or sum.

Millus, *Federal v. State Control of Workmen's Compensation Programs*, TRIAL, Mar. 1979, at 28.

30. *See id.* at 28-29.

31. *Id.* at 31.

32. *Id.* at 29, 31.

33. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES (1975) [hereinafter cited as FASB STATEMENT NO. 5]. This Statement is considered a generally accepted accounting principle (GAAP). As such, it is a rule to be followed by the public accountant if a financial statement issued by a publicly held corporation is to be certified. FASB statements have been incorporated by reference into the Securities and Exchange Commission (SEC) regulations. Annual reports or financial statements requiring SEC approval cannot be issued without complying with the FASB statements. FASB statements do not apply to financial practices of privately held companies not needing or unconcerned with certification by a public accountant except by persuasion. FASB statements also do not apply to not-for-profit institutions which neither have shareholders nor seek SEC approval of their financial statements. *See* Smith, *Self-Insurance and FASB-5*, in SELF-INSURANCE: A RISK MANAGEMENT ALTERNATIVE 16 (Society of Chartered Property and Casualty Underwriters ed. 1978) [hereinafter cited as SELF-INSURANCE].

34. FASB Statement No. 5 defines "contingency" as "an existing condition, situation,

crued by a charge to income if *both* of the following conditions are met: (1) "information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability[35] had been incurred at the date of the financial statements[36] [and it is] probable[37] that one or more future events will occur confirming the fact of the loss"; and (2) "the amount of the loss can be reasonably estimated."[38] FASB Statement No. 5 can be applied to reserves for workers' compensation claims by analogy to examples given in the statement and by analyzing the statement's underlying rationale.

Although FASB Statement No. 5 does not address specifically the issue of accounting for workers' compensation losses, the statement does address analogous loss exposures. These areas include obligations related to product warranties and defects;[39] risk of loss or damage to enterprise property;[40] risk of loss from future injury to others, damage to property of others, and business interrup-

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or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." FASB STATEMENT NO. 5, *supra* note 33, at 1. "The term *loss* is used for convenience to include many charges against income that are commonly referred to as *expenses* and others that are referred to as *losses*." *Id.* at 1 n.1.

35. A "liability" has been defined as "claims of creditors against the enterprise, arising out of past activities, that are to be satisfied by the disbursement or utilization of corporate resources." *Id.* at 30 (quoting AMERICAN ACCOUNTING ASSOC., ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS AND PRECEDING STATEMENTS AND SUPPLEMENTS 16 (1957)). A liability also has been described as being "the result of a transaction of the past, not of the future." Moonitz, *The Changing Concept of Liabilities*, 109 J. ACCT. 41, 44 (1960).

36. "Date of the financial statements" is interpreted as "the end of the most recent accounting period for which financial statements are being presented." FASB STATEMENT No. 5, *supra* note 33, at 4 n.4.

37. FASB defines "probable" in FASB Statement No. 5 as meaning that "the future event or events are likely to occur." *Id.* at 2.

38. *Id.* at 4. This test of "reasonable estimation" or quantifiability of loss is consistent with most definitions of liabilities generally requiring that the amount of an economic obligation be known or susceptible of reasonable estimation before it is recorded as a liability. *See* FASB STATEMENT NO. 5, *supra* note 33, at 31 (quoting AMERICAN ACCOUNTING ASSOC., ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS AND PRECEDING STATEMENTS AND SUPPLEMENTS 16 (1957)).

39. *See* FASB STATEMENT NO. 5, *supra* note 33, at 12-13. Due to the uncertainty surrounding claims made by warranties, warranty obligations are accruable contingencies when (1) "based on available information, it is probable that customers will make claims under the warranties relating to goods or services that have been sold," and (2) the liability is estimable by looking to the experience of the enterprise or to the experience of other enterprises in the same business. *Id.* at 12.

40. *See id.* at 13-14. Uninsured risks or the deductible portions of insured risks pertaining to random loss or damage of enterprise property are accruable on the occurrence of the event, e.g., fires, explosions, storms, giving rise to the loss. *Id.*

tion;[41] and litigation claims and assessments.[42]

The virtual certainty or strong probability of liability, as well as the reasonable estimability of such liability, underlie these analogous loss exposures. Since liability for workers' compensation claims is fixed by state law, with the only contingency being the extent of payments which must be made to beneficiaries, application of FASB Statement No. 5 to uncontested claims for workers' compensation benefits necessitates accrual of the claim.[43] The amount of the liability is a function of the present value of the periodic payment fixed by law multiplied by the number of periods payable. The periods payable are either fixed by law or subject to medical and actuarial evaluations based on the extent of bodily impairment, duration of disability, and estimated life expectancy of beneficiaries.[44] Estimates as to experience of losses by the enterprise and experiences of other similar enterprises are additional factors allowable for assessment with respect to probability of liability. These factors, however, bear on the extent or value of the liability and not on its imposition, an admitted fact

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41. *See id.* at 14-15.

> [T]he conditions . . . [for accrual] would be met with respect to uninsured [or self-insured] losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements, even though the enterprise may not become aware of those matters until after that date, if the experience of the enterprise . . . enables it to make a reasonable estimate of the loss that was incurred prior to the date of its financial statements.

Id. at 15.

42. *See id.* at 16-19. Threatened or actual litigation, claims, or assessments may lead to liability and accrual if the period in which the underlying cause of action has occurred falls within the period of the current financial statements. An enterprise, in accounting for unasserted claims or assessments, must determine the "degree of probability that a suit may be filed or a claim or assessment may be asserted" in the current period. Probability of unfavorable outcome and reasonable estimability of the loss are additional requirements for accrual of liability. *Id.*

43. The loss exposure area most closely related to workers' compensation claims is estimated liability for unemployment claims. Although not mentioned in FASB Statement No. 5, the American Institute of Certified Public Accounts (AICPA), in AICPA TECHNICAL PRACTICE AIDS—STATEMENTS OF POSITION OF THE ACCOUNTING STANDARDS DIVISION § 3100.01 (July 1979), states:

> The estimated unemployment insurance costs should be accrued currently based on the client's estimated or past history of unemployment. Unemployment insurance cost should be related to the period worked by the employees. Not recording unemployment costs until claims are actually filed would result in a mismatching of revenues and expenses. Such an approach would be unacceptable under generally accepted accounting principles.

Id.

44. Thus, calculation of the liability for accounting purposes is a function of general present value or time value of money concepts and the various factors which are used to compute liability under the many workers' compensation statutes. *See supra* note 28.

by an enterprise choosing not to contest its liability to the employee.

Thus, the proper financial accounting treatment for uncontested claims is the charging of the present value of the periodic payment fixed by law multiplied by the number of periods payable against income in the year in which the claim arose. An additional corresponding liability should be accrued for the unpaid portion of the claim. The liability then should be amortized over the payment period of the claim.[45]

Claims contested on the basis of whether the injury arose in the course of employment should be considered as any normal litigation and may lead to accrual, depending on the facts.[46] Claims contested on the basis of percentage of disability should be treated similarly, but unlike claims contested on the basis of injury in the scope of employment, liability should be fixed. The basis of these claims is merely the fair adjudication of the extent of liability.

In addition to asserted workers' compensation claims, contested or uncontested, FASB Statement No. 5 may further apply to require accrual of current unreported claims arising from injuries in the current financial reporting period. As with product and warranty liability[47] and liability for unasserted claims generally,[48] liability may have to be accrued on the basis of estimates of past experience or other available information.

The second analytic mode for applying FASB Statement No. 5 to workers' compensation losses is found in the statement's four underlying rationales. First, financial accounting should reflect primarily the effects of past, not future, transactions and conditions.[49] This rationale, however, is not totally "past-oriented." Accrual of a loss need not wait until the confirming future event occurs. All that is required for such accrual is that some confirming future event will occur.[50] In the workers' compensation claim context, the event required to establish liability is the necessity of

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> [E]xposure to risk of uninsured injury to others . . . does constitute an existing condition involving uncertainty about the amount and timing of any losses that may occur, which gives rise to a contingency. The matching principle requires that incurred but unpaid expenses and the related liabilities be estimated in advance and reported in the financial statements on an accrual basis.

D. KIESO & J. WEYGANDT, INTERMEDIATE ACCOUNTING 417 (2d ed. 1977).

46. *See supra* note 42.

47. *See supra* note 39.

48. *See supra* note 42.

49. FASB STATEMENT NO. 5, *supra* note 33, at 29.

50. *Id.* at 30.

making payment to the injured employee for the statutorily imposed liability. This event is subject to actuarial estimation.

The second rationale focuses on the existence of a "liability."[51] Beneficiaries of workers' compensation will be paid from enterprise resources. The event giving rise to a claim results from an event within the last accounting period; the amount of the liability is estimable by using fixed state or federal award amounts and actuarial evaluations. Thus, within the purview of FASB Statement No. 5, a liability exists.

Third, the proper matching of expenses associated with the injury of an employee engaged in the production of goods or services in a particular year is to be charged against that year's income. The expense is a cost of doing business that year.[52]

Finally, the principle of conservatism[53] requires early or present recognition of expenses or losses when the two criteria of FASB Statement No. 5 are met.[54] This requirement exists primarily because early recognition of unfavorable events and minimization of the amounts of net assets and net income are desirable in financial accounting. Thus, current accrual of losses due to workers' compensation claims is consistent with both the matching and the convervatism principles. Claims which are uncontested or contested only as to the *amount* of liability, and perhaps even claims contested as to the existence of liability, may properly be accruable currently. Application of FASB Statement No. 5 by analogy to examples in the statement itself and analysis of the underlying rationales of the statement dictate that current accrual is the proper financial accounting treatment for workers' compensation claims.

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51. *See supra* note 35.

52. The matching concept refers to the entire process of income determination: identifying, measuring, and relating revenues and expenses of an enterprise for an accounting period. It is the recognition of expense by associating costs with revenue on a cause and effect basis. *See* FASB STATEMENT No. 5, *supra* note 33, at 33-34. *See generally* D. KIESO & J. WEYGANDT, *supra* note 44, at 29-31.

53. Conservatism is indicated as one of the "characteristics and limitations" of financial accounting in paragraph 35 of *APB Statement No. 4* as follows:

> *Conservatism.* The uncertainties that surround the preparation of financial statements are reflected in a general tendency toward early recognition of unfavorable events and minimization of the amount of net assets and net income.

FASB STATEMENT No. 5, *supra* note 33, at 35. There is a preference that any possible errors in measurement be made in the direction of understatement rather than overstatement of net income and net assets. *See id. See generally* D. KIESO & J. WEYGANDT, *supra* note 44, at 37.

54. See *supra* notes 34-38 and accompanying text for a discussion of these criteria.

In summary, managing the risks associated with employer liability for workers' compensation has become a crucial task for most enterprises, especially because of the great financial impact on the enterprise. The task is complicated by the multiplicity of state regulations and constrained by the accounting profession's requirement of disclosing transactions and plans in a prescribed manner. To refine the analysis in this Note, the workers' compensation transaction is examined in the context of self-insurance as the risk management vehicle.

II. SELF-INSURANCE

Self-insurance is a popular and effective technique of risk management, although other techniques, such as retrospectively rated insurance policies,[55] section 501(c) trusts,[56] and captive insurance companies[57] also are gaining recognition. The term "self-

55. Retrospective insurance is a contract taking actual losses into account in calculating a premium. Premiums include a basic amount providing for insurer's overhead, commissions, and profits, to which is added a standard amount developed from a review of actual exposures and actual cost of claim administration. The sum of these premiums is adjusted to account for state imposed taxes. The final premium is subject to a minimum and a maximum level or amount. *See* R. MEHR & E. CAMMACK, PRINCIPLES OF INSURANCE 613-15 (6th ed. 1976); W. RODDA, PROPERTY AND LIABILITY INSURANCE 431 (1966).

56. *See* I.R.C. § 501(c) (1976). A trust may be used to fund retained risk. The more familiar and widespread use of the trust is to fund pension plans. Trusts, however, may be used to fund voluntary employees' beneficiary associations providing for the payment of life, sickness, or accident insurance, or other benefits to association members or dependents for long-term disability and medical services. *Id.* § 501(c)(9). Trusts also have been used to fund the payment of supplemental unemployment compensation, *id.* § 501(c)(17), and to fund liability with respect to claims for compensation for disability or death due to pneumoconiosis under Black Lung Acts. *Id.* § 501(c)(21). The advantages of a trust with § 501 status are the tax-exempt status of investment earnings and the reduction or elimination of premium taxes, commissions, and underwriters' profits. One disadvantage is that the settlor organization generally must relinquish direct control of claim reserves. *See, e.g.,* Treas. Reg. § 1.501(c)(9)-2 (1980). *Cf.* Rev. Rul. 74-18, 1974-1 C.B. 139 (certain workers' compensation trusts do not qualify under § 501(c)(9)).

57. A captive insurance company is one which primarily insures the risks of its parent(s). It is, in effect, a formalization of self-insurance. Captives generally are classified by their ownership and the risks they insure. United States multinational corporations historically have used captives "to reinsure portions of the risks insured by the overseas affiliate of the United States insurers." Graves, *The Insurance Subsidiary: Self-Insurance Formalized*, in SELF-INSURANCE, *supra* note 33, at 34, 34. The most "recent area of captive use is domestic casualty insurance (workers' compensation, products liability, general liability, and automobile liability)." *Id.* Corporations owning captives generally enjoy such advantages as lower cost of risk, broader coverage of risk, and increased capacity to deal with risks. *Id.*

The most controversial advantage of using captives is the claim of tax deferral. If the premiums paid to the captive are tax deductible expenditures to the parent under I.R.C. § 162, the parent is in effect getting a deduction for a funded self-insurance program. For insurance" actually may be a misnomer. Traditional insurance concepts involve risk transfer. Since risk is retained in self-insurance, it is not insurance per se. Self-insurance has been defined as a "plan of risk retention in which a program or procedure has been established to meet the adverse results of a financial loss which are not protected by insurance."[58] If an employer carries workers' compensation insurance from a casualty insurance company, self-insurance is the portion of the risk or "deductible" retained by the insured.[59]

Self-insurance traditionally could not be utilized unless risks could be pooled. Pooling is the aggregation of many homogeneous risks free from catastrophic loss from which statistical conclusions may be drawn to provide an accurate prediction of future losses.[60] Another customary requirement for self-insurance to be feasible was the ability to establish an actuarily sound fund to cover losses. Modern fundamentals for self-insurance merely require a risk retention plan in which a program or procedure has been established to meet adverse results of a financial loss.[61]

Workers' compensation is unusually adaptable to the self-insurance technique. Benefits are prescribed by state or federal law and are relatively moderate in size. Few compensation cases provide a recovery of such magnitude that a serious drain on enterprise assets would result. Because claims are generally payable over a period of years, payments for losses incurred can be budgeted. Furthermore, predictability is obtained through precise actuarial estimates. Finally, self-insurers can develop their own claims staffs, thereby dispensing with outside insurance adjusters.

Self-insuring workers' compensation claims provides several advantages. First, the employer's loss prevention incentive is enhanced by an awareness that loss indemnification comes directly from enterprise profits, rather than from the security buffer offered by outside insurance. A more direct incentive to reinstate the employee quickly may be present at the management level.[62] Second, workers may be more conservative in claiming against their own employers than they would be against a third party insurer.

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reaction to this issue by the Internal Revenue Service (the Service) and the Tax Court, see Rev. Rul. 77-136, 1977-2 C.B. 53; Carnation v. Commissioner, 71 T.C. 400 (1978).

58. RISK AND INSURANCE, *supra* note 12, at 79.

59. *See id.*

60. *Id.*

61. *Id.*

62. Warren, *Self-Insurance, An Overview*, in SELF-INSURANCE, *supra* note 33, at 3, 7.

Third, employer contributions to the reserve accounts established to satisfy state statutory funding and financial reporting requirements in the year of the accrual of the loss may provide favorable tax treatment for self-insurers if a deduction for these accruals is allowed.

This Note focuses on the tax treatment of these contributions. The characteristics of the self-insurance technique are affected greatly by the exigencies of state statutory requirements designed to ensure the security of employer responsibility for employment-related injury and disease. The financial statement presentation and disclosure required by generally accepted accounting principles (GAAP) constitute further constraints. The interplay of statutory liability, independent accounting requirements, the Internal Revenue Code (the Code), and subsequent executive and judicial interpretations of the Code form the basis for allowing or disallowing a deduction for reserves by self-insuring employers. The federal tax law authorizing deductions for reserves in general, and for self-insurance reserves specifically, is the focus of the next section.

III. Federal Income Tax Treatment of Reserves for Contingent Liabilities and Accrued Expenses

The statutory authority for the deduction of business expenses, including certain reserves and accrued expenses, is section 162 of the Code.[63] The statute and regulations thereunder prescribe three tests for proper deductibility of an expense. The expenses must be ordinary[64] and necessary,[65] made in pursuance of a trade

63. I.R.C. § 162(a) (1976) states in pertinent part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." The remainder of § 162 addresses specific examples of deductible and nondeductible items. Neither reserves nor accrued expenses are mentioned.

Treas. Reg. § 1.162-1(a), T.D. 7345, 1975-1 C.B. 52 provides in part: "Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162."

64. *See* Tank Truck Rentals v. Commissioner, 356 U.S. 30 (1958) (expense is ordinary if it is normal, usual, or customary in the type of business involved and if it is not capital or personal in nature); Deputy v. DuPont, 308 U.S. 488 (1939), where the Court stated: "The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling." *Id.* at 496.

65. *See* Welch v. Helvering, 290 U.S. 111, 113 (1933) (necessary defined as meaning "[a]ppropriate and helpful").

or business,[66] and paid[67] or incurred.[68] Self-insurance reserves usually meet these criteria. The issue with respect to reserves in general and self-insurance reserves in particular is whether an accrued expense or contingent liability has been "incurred" in the tax sense. The dispute arises because of the divergence between accrual accounting procedures for tax and financial reporting purposes.[69] This dispute is primarily a result of judicial interpretation

66. Neither the Code nor the Treasury Regulations defines "trade or business." The Service has compiled several judicial interpretations to formulate the following characteristics for a trade or business: (1) a pursuit carried on for livelihood or for profit; or (2) a pursuit in which a profit motive is present and where there is some type of economic activity involved, i.e., actual intent of realizing a profit and producing income; or (3) activity to produce income (passive income, e.g., that from investments, does not qualify). DEP'T OF THE TREASURY, I.R.S. PUB. 334, TAX GUIDE FOR SMALL BUSINESSES 3 (rev. Nov. 1979). In the landmark decision of Doggett v. Burnet, 65 F.2d 191 (D.C. Cir. 1933), the court stated:

> The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it [the enterprise] is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion.

Id. at 194.

67. "Paid" is given its plain meaning. This requirement is satisfied where there has been a tender of cash, check, note, stock, etc. *See, e.g.*, P.G. Lake, Inc. v. Commissioner, 148 F.2d 898, 900 (5th Cir. 1945).

68. The heart of the issue of whether an accrued expense or a reserve for a contingent liability will be deductible is whether an expenditure has been "incurred" within the meaning of I.R.C. § 162. See *infra* notes 201-39 and accompanying text for a discussion of this issue. Briefly, the determinative factor is whether the "all events" test embodied in Treas. Reg. § 1.461-1(a)(2) (1957) is satisfied: "Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." *Id.*

69. Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969), described the role of accrual accounting in the tax context:

> "Income" has been defined as "a net or resultant determined by matching revenues with related expenses." Since the Internal Revenue Code allows the deduction of substantially all business expenses it seems reasonably clear that Congress intended to tax only net business income. This objective, however, is complicated by the fact that the tax is exacted on an annual basis whereas business transactions are often spread over two or more years. A business may receive payment for goods or services in one tax year but incur the related expenses in subsequent tax years. The result is that the expenses cannot be used to offset the receipts, and the full amount of the receipts is taxed as though it were all net "profit."
>
> The purpose of "accrual" accounting in the taxation context is to try to alleviate this problem by matching, in the same taxable year, revenues with expenses incurred in producing those revenues. Accurate matching of expenses against revenues in the same taxable year may occur either by "deferring" receipts until such time as the related expenses are incurred or by "accruing" estimated future expenses so as to offset revenue. Under the deferral concept, present receipts are not recognized as "income" until they are "earned" by performing the related services or delivering goods. . . . A corresponding principle states that expenses

of the scant applicable sections of the Code.

In *United States v. Anderson*,[70] the Supreme Court promulgated the "all events" test for determining the deductibility of accrued expenses. The Court stated that an accrual basis taxpayer's reserve for its munitions profits tax liability only could be deducted from gross income in the year in which the reserve properly appeared on its books, rather than the following year when the exact amount of the liability was actually paid. Since all the events which fixed the *existence* and *amount* of the liability had occurred in the prior year, the Court reasoned that the deduction must be used to offset the prior year's income to accurately reflect taxable income therein.[71] The all events test has been adopted widely by lower courts and subsequently has been embodied in the regulations.[72] Thus, an accrued expense or reserve for a contingent liability will be deductible in the current tax year if it is the year in which all the events have occurred which determine liability and the liability amount can be determined reasonably accurately. Applying this ruling has confused the courts for over fifty years.[73]

This Note proceeds by analyzing the first part of the all events test—the issue of sufficiency of existing facts to fix a liability. Six categories of standards that the courts have considered probative on this issue are examined. Once the liability is established, the standards the courts have used to determine the second part of the all events test—the reasonable estimability of the liability amount—are reviewed. After deriving these judicial standards, they are applied to self-insurance for workers' compensation transactions.

A. *Determination of the Existence of a Liability*

Neither the Code, Treasury Regulations, nor common law provides a clear standard for judging whether a liability has been incurred for accrual and deduction purposes. The courts, how-

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> are to be reported in the year the related income is "earned" whether or not actually paid in that year.

Id. at 402-03 (footnotes omitted).

70. 269 U.S. 422 (1926).

71. *Id.* at 441.

72. Treas. Reg. § 1.461-1(a)(2) (1957): "Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy."

73. *See infra* text accompanying notes 80-200.

ever, consistently have considered several factors probative in determining liability: (1) whether there is a fixed obligation imposed by statute;[74] (2) whether there is a fixed obligation imposed by contract;[75] (3) whether the time of payment is determinate;[76] (4) whether the particular accrual accounting system clearly reflects income for tax purposes;[77] (5) whether the taxpayer is contesting the liability's existence through litigation or otherwise;[78] and (6) whether facts which trigger liability are conditions precedent or subsequent to the facts establishing the liability.[79]

1. *Statutory Obligation*

Some courts have held that state statutes may sufficiently fix the existence of liability within the meaning of the all events test. In *Denise Coal Co. v. Commissioner*,[80] a strip mine operator was required to back fill an open mine after completing strip mining operations and to post bond to ensure performance. The court held that the taxpayer could accrue and deduct the estimated cost of rehabilitation in the year the property was mined. The court stated:

> The Pennsylvania statute imposes a fixed and definite obligation. We cannot suspect these taxpayers of an intention not to fulfill it. . . .
>
> . . . . We think it is good business and good accounting and, therefore, ought to be good tax law to allow a reasonable estimate to be set up as a reserve for the fulfillment of this statutory obligation.[81]

The Service has been hostile to this position. In a private letter ruling,[82] the Service denied a favorable determination to a strip

74. *See infra* text accompanying notes 80-91.

75. *See infra* text accompanying notes 92-105.

76. *See infra* text accompanying notes 107-11.

77. *See infra* text accompanying notes 112-31.

78. *See infra* text accompanying notes 153-64.

79. *See infra* text accompanying notes 165-78.

80. 271 F.2d 930 (3d Cir. 1959). *See also* Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951) (cost of refilling strip mine held deductible in year of occurrence, even if not ascertainable until following year).

81. 271 F.2d at 935-36.

82. The value of a private ruling is limited, as far as precedent is concerned, to the taxpayer to whom it is issued. I.R.C. § 6110(j)(3) (1976) states that, "[u]nless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent." A private ruling is nonetheless useful in that it is indicative of the Service's position and reasoning with respect to a certain transaction under specific circumstances.

miner situated analogously to the taxpayer in *Denise Coal*.[83] The Service gave three reasons why the statutory obligation did not satisfy the "fixation of the liability" requirement. First, where an anticipated expenditure is for the taxpayer's performance of services or the payment for services rendered by a separate entity, no deduction is allowable prior to actual performance. Neither the liability itself nor payment of the service expense becomes fixed, and hence deductible, within the meaning of Treasury Regulation Section 1.461-1(a)(2) until the taxable year in which such services are actually rendered.[84] Second, the Service reasoned that the taxpayer's liability to the state is not a fixed tax liability, but rather the taxpayer's motivation for engaging in behavior giving rise to a deduction. The reason a taxpayer incurs an expense is not relevant in determining *when* such expense was incurred.[85] Last, the Service asserted:

> [S]tates, counties, municipalities, etc., impose statutory obligations or duties upon their corporate or individual residents other than the reclamation of land strip-mined for coal. To permit herein a reclamation expense deduction for the taxable year the mining is completed is analogous to allowing a taxpayer an expense deduction for the preparation by the taxpayer, or a contracted for attorney or accountant, of certain filing and information forms pursuant to a statutory obligation in the taxable year such statutory duty arises but prior to the time such legal or accounting services are rendered, paid for, or due.[86]

World Airways, Inc. v. Commissioner[87] reached a contrary conclusion on facts similar to *Denise Coal*. The taxpayer, an air charter service, was required by the Federal Aviation Administration (FAA) to overhaul its jet engines and airframes at prescribed intervals.[88] Pursuant to these regulations, the taxpayer contracted with a commercial airline to perform the maintenance and repairs.[89] For each hour flown, an accrual was established for the cost of maintenance required by the FAA, although the work was to be performed and paid for at prescribed intervals. The taxpayer argued that federal regulation had imposed a liability, and

83. 75 IRS LETTER RULING REP. (CCH) 7,831,003, at 14 (April 13, 1978). This case also involved accrued expenses for statutorily imposed land reclamation obligations.

84. *Id.* at 15.

85. *Id.* at 16-17.

86. *Id.* at 17.

87. 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

88. *Id.* at 789-90.

89. *Id.* at 790.

therefore, it was entitled to a deduction for its accrual. With respect to the Civil Aeronautics Board (CAB) requirement that each taxpayer must establish a reserve account for required maintenance, the court stated:

> It is apparent then, that the accounting procedures required by the CAB are designed for financial reporting purposes and to facilitate CAB objectives. The regulations themselves recognize their divergencies from tax accounting and do not pretend to establish practices contrary to or even related to accounting procedures for tax purposes.[90]

The court carefully distinguished *Denise Coal* by reasoning that no statutory obligation to overhaul arises until a plane containing the airframe or engine has been flown the applicable number of flight hours. Because the *operative* facts had not occurred during the taxable years in question, the petitioner's liability for the overhaul costs had not become fixed.[91]

It can be concluded that a statutory obligation to perform an act may be accepted by some courts as "fixing a liability" in limited cases where all *operative* facts giving rise to the obligation have occurred. It is likely, however, that the Service will continue to oppose this position.

2. *Contractual Obligation*

The second category in which courts have found sufficient facts to fix liability is where the taxpayer incurs a valid contractual liability. The Service and the courts agree that the existence of a contractual obligation suffices to establish liability. A problem arises, however, because the courts appear more flexible than the Service in accepting certain contractual situations as binding in establishing a fixed liability.

In *Washington Post Co. v. United States*,[92] a taxpayer instituted a dealer profit sharing plan whereby the Post agreed to accrue annually a share of its net profits for the benefit of eligible dealers. The total accrued to the plan was determined at the end of the year and the amount then was allocated among various accounts for individual dealers.[93] A dealer's share was subject to forfeiture provisions for discontinuance of the contractual relationship with the Post. The forfeited amount then would be dis-

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90. *Id.* at 800.
91. *Id.* at 803.
92. 405 F.2d 1279 (Ct. Cl. 1969).
93. *Id.* at 1281-82.

tributed among the remaining dealers' accounts. Although the Post reserved the right to unilaterally terminate or alter the plan, it was obligated irrevocably to distribute the amount accrued at the time of discontinuance.[94] Thus, the Post was obligated absolutely to pay the amount accrued under the plan; the only uncertainty was the logistics of allocation among the various accounts. The court held that because the Post was obligated irrevocably to pay the accrued amounts, this sum was fixed at the time of accrual.[95] Under the all events test, the certainty of the obligation to pay a fixed amount is not impaired by uncertainty of either the identity of the ultimate recipients or the time of actual payment.[96] The court concluded that the crux of the all events test is the "certainty of the liability" when a group liability is involved.

The Service disagreed with the Post and maintained that the all events test only can be satisfied "when the fact of the liability to a specified individual participant has been clearly established and the amount of liability to each individual can be determined with reasonable accuracy."[97] The Service appears to focus on incidents of the certainty of the obligation which should assume controlling significance only where the facts are unclear as to whether a fixed liability exists. The Service thus fails to confront the issue of whether the creation of a definite and fixed liability satisfies the all events test.[98]

Case law, however, squarely addresses the issue of whether the creation of a definite and fixed liability itself satisfies the all events test. In *Lukens Steel Co. v. Commissioner*,[99] the court upheld deductions for accruals under a supplemental unemployment benefits (SUB) plan. Although the ultimate recipient was unknown and the time and amount of payment was uncertain, the court concluded:

> At the end of the company's fiscal year, the amount of the liability [was] determined by events which happened during that year. . . . [T]he United Steelworkers of America [was] the group from which the recipients must come, and the total amount payable at any given time [was] determinable.[100]

94. *Id.* at 1282.

95. *Id.* at 1283.

96. *Id.* at 1284.

97. Rev. Rul. 76-345, 1976-2 C.B. 134-45.

98. *See* Note, *Deductibility of Deferred Compensation Plans Under the "All Events" Test*, 30 TAX LAW. 780, 785 (1977).

99. 442 F.2d 1131 (3d Cir. 1971).

100. *Id.* at 1135. *See also* Cyclops Corp. v. United States, 480 F. Supp. 1287 (W.D. Pa.

Thus, the identification of specific payees was not required to satisfy the all events test.

A case which reached a similar result on like facts was *Rath Packing Co. v. Bacon*.[101] The taxpayer entered into a collective bargaining agreement with the union whereby the taxpayer agreed to establish a fund with a predetermined contribution formula. The fund's proceeds were to be used to finance a committee to study and make recommendations for the solution of job displacement problems.[102] There was an accrual by the taxpayer for the predetermined amount but the committee was never formed and a payout was never made.[103] In allowing the deduction, the court held that the taxpayer's obligation was fixed by contract, stating: "[D]eduction[s] must be viewed in light of the circumstances existing when the contract obligation was incurred."[104] The liability thus was deemed fixed despite the non-existence of an ultimate fund beneficiary.

Many courts posit that the decisive factor under the all events test is the "creation of an enforceable liability" in the year of accrual.[105] Thus, the courts appear somewhat more liberal than the Service concerning when a contractual obligation will "fix a liability," and seem to require less specificity with respect to payees and time of actual payout by the taxpayer. The crucial questions are which events fix the liability, and which aspects of the liability are collateral details.

3. *Time of Payoff*

Indeterminacy as to time or payment amount has been grounds for some courts to disallow a deduction. In *Lukens Steel*,[106] uncertainty as to the time of actual payment of the liability did not disqualify accrual of the liability. The majority of the court was convinced that the amount accrued would be paid in a

1976). In upholding accruals to a SUB plan, the court concluded that time of actual payment is immaterial under the all events test, as long as there is "virtual certainty of full payment of the delayed obligation to eligible employees within a reasonable period of time." *Id.* at 1298.

101. 255 F. Supp. 809 (S.D. Iowa 1966).

102. *Id.* at 809-10.

103. *Id.* at 811.

104. *Id.* at 812.

105. *See, e.g.*, Kershaw Mfg. Co. v. Commissioner, 313 F.2d 942, 945 (5th Cir. 1963); Clark v. Woodward Constr. Co., 179 F.2d 176, 177 (10th Cir. 1950); Willoughby Camera Stores, Inc. v. Commissioner, 125 F.2d 607, 609 (2d Cir. 1942).

106. 442 F.2d 1131 (3d Cir. 1971). *See supra* text accompanying notes 99-100, for a discussion of this case.

"reasonable" period of time. A broad reading of the majority opinion indicates that payment within a "reasonable" time will not destroy the deductibility of an accrued item when the liability amount is absolutely fixed. In his concurrence, Chief Judge Hastie stated:

> Since it was probable that the accruals to the fund would have to be paid out within a relatively short time, it is unnecessary to decide whether sums committed to such a fund as this are . . . immediately deductible as an accrued business expense if the time of future disbursement is entirely speculative and is as likely to occur decades hence as in the near future. Yet the opinion of the Court seems broad enough to cover that situation.[107]

Thus, if it is possible that payment will be made soon, accrual of the liability will not be disqualified because of uncertainty as to time of actual payment.

In *Mooney Aircraft, Inc. v. United States*,[108] the court disqualified accrual of a liability because of its uncertainty as to time and payment, despite its existence as fixed by facts occurring in the taxable year. Taxpayer, an aircraft manufacturer, issued a document entitled "Mooney Bond" with each aircraft sold. This document created an unconditional and legally binding promise that taxpayer would pay $1,000 to the bearer when the aircraft was retired permanently from service. The court admitted that although there was no contingency as to the *fact* of the liability, there was a contingency as to *when* the liability would arise. The court stated, "The most salient feature in this case is the fact that many or possibly most of the expenses which taxpayer wishes to presently deduct will not actually be paid for 15, 20, or even 30 years."[109] Accrual of the liability was so removed from the time the money would be received by the bondholders that it would attenuate completely, if not break, any relationship between the two. Furthermore, the court averred that "[t]he longer the time the less probable it becomes that the liability though incurred, will ever in fact be *paid*."[110] To justify its conclusion, the court relied on one of the underlying rationales of the all events test—the protection of federal tax revenues by ensuring that the taxpayer will not take deductions for expenditures that might never occur.[111]

107. 442 F.2d at 1135-36.
108. 420 F.2d 400 (5th Cir. 1969).
109. *Id.* at 409.
110. *Id.* at 410.
111. *Id.* at 406.

Lukens and *Mooney* represent the tension existing between conflicting rationale for the all events test. Sometimes the judicial test, "existence of all facts fixing liability," conflicts with the government's desire to protect the federal tax revenues. *Lukens* is distinguishable from *Mooney* because in *Lukens*, actual payment or commencement of a stream of payments reasonably could be expected to occur in the near future. In *Mooney*, however, the bonds did not mature for several years and payment was certain to begin only after several years. Thus, the question as to time of payment appears open. The greater the uncertainty of actual payment and the longer the time period before payment commences, however, the less likely it is that the courts will allow the deduction under the all events test.

4. *Integration of Accounting Methods*

Section 446 of the Code requires that a taxpayer compute taxable income using the same accounting method employed for its financial reporting purposes.[112] Most corporate taxpayers are accrual basis taxpayers, and the Code specifically recognizes this method as acceptable.[113] The Code, however, places a qualitative restriction on acceptability of a tax accounting method, requiring that it "clearly reflect income."[114] This qualitative test has caused substantial litigation[115] involving three subissues which are central to whether an accrued expense or, more specifically, a reserve for a workers' compensation loss is deductible in the year in which the expense or loss was incurred.

The first subissue in determining the acceptability of a particular acounting method is whether the method's reflection of income for tax purposes should be evaluated by an independent standard, or whether the Service has absolute discretion to disallow any ac-

112. I.R.C. § 446(a) (1976) provides: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

113. *Id.* § 446(c)(2).

114. *Id.* § 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

The applicable Treasury Regulation states: "If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which in the opinion of the Commissioner, does clearly reflect income." Treas. Reg. § 1.446-1(b)(1) (1957).

115. *See* Arbesfeld, *GAAP, the AICPA, and the Tax Law*, 52 TAXES 18 (1974); Moody, *The Relationship of Financial and Tax Accounting*, 57 TAXES 920 (1979).

counting method which it believes does not clearly reflect income. For purposes of this Note, if such a viable independent standard exists and if adherence to GAAP indicates fulfillment of this standard, then taxpayers accruing or creating reserves for losses due to workers' compensation obligations could currently deduct these accruals. By adhering to GAAP, the taxpayer will, by definition, reflect income for both financial reporting and tax purposes. Thus, adherence to GAAP is the second subissue in determining whether an accounting method clearly reflects income. The third subissue concerns the effect the retroactive repeal of sections 452 and 462 of the Code should have on determining whether an accounting method clearly reflects income.

a. *Commissioner's Discretion*. In *Lucas v. American Code Co.*,[116] the Supreme Court stated: "[S]ince the Commissioner has much latitude for discretion, his interpretation of the statute's clear-reflection standard should not be interfered with unless clearly unlawful."[117] This judicial deference to the Commissioner's interpretations was reaffirmed recently in *Thor Power Tool Co. v. Commissioner*.[118] The taxpayer had sought to devalue and immediately expense its excess and obsolete inventory to comply with GAAP and then deduct this write-down for tax purposes. The Supreme Court held that the taxpayer bears a heavy burden of proof when seeking to overturn the Commissioner's findings. Furthermore, the Commissioner's disallowance of an accounting method will not be set aside unless plainly arbitrary.[119]

Some lower courts have attempted to limit the Court's position by implying the existence of situations in which the taxpayer's accounting method will so clearly reflect income that rejection by the Commissioner would constitute an abuse of discretion.[120] In

116. 280 U.S. 445 (1930). The taxpayer breached an employment contract with an employee by firing him without sufficient cause before the contract expired. The employee sued the taxpayer who contested the liability. During the period of contest, however, the taxpayer sought to accrue and deduct the commissions that would have been payable had the contract not breached. For further discussion of *American Code Co.*, see *infra* text accompanying notes 153-54.

117. 280 U.S. at 449. *See, e.g.*, American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Commissioner v. Hansen, 360 U.S. 446 (1958); Lucas v. Structural Steel Co., 281 U.S. 264 (1930).

118. 439 U.S. 522 (1979).

119. *Id.* at 532-33. *See also* Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978) ("characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other hand, need not necessarily be the same").

120. *See, e.g.*, Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970);

RCA v. United States,[121] RCA sought to defer prepaid income received from the sale of service contracts for television sets. RCA argued that income from these contracts was earned in subsequent years and that its accounting method clearly reflected income.[122] The court outlined the statutory test of an acceptable accounting method:

> The proper test, under the statute, remains whether the accounting method in question 'clearly reflects income'—that is, in our view, whether it ensures, with reasonable precision, that deferred revenues are included in gross income in tax years subsequent to that in which they are received only in proportion to the related services performed, and expenses incurred, during those tax years.[123]

Thus, the test of whether an accounting method clearly reflects income is whether the method accurately matches gross income with the expenses of producing the income in the year the expenses are incurred.[124] The court also concluded that RCA was entitled, as a matter of law, to use its accounting method for tax purposes because it passed muster under the court's interpretation

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Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968); Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl.), *cert. denied*, 429 U.S. 867 (1976).

121. 499 F. Supp. 507 (S.D.N.Y. 1980).

Subsequent to completion of this Note, the Second Circuit Court of Appeals reversed the RCA v. United States decision. 664 F.2d 881 (2d Cir. 1981). In its opinion, the court stated that the Commissioner's exercise of discretion must be upheld unless it is found to be clearly unlawful. Thus, the court asserted that the task of a reviewing court is not to determine whether in its own opinion the taxpayer's method of accounting clearly reflects income, but rather to determine whether there is an adequate basis in law for the Commissioner's conclusion that it does not. *Id.* at 886. The Second Circuit appears to be articulating a test for review which is much narrower in scope than that formulated by the district court. While the Second Circuit focuses on whether there is some lawful basis for upholding the Commissioner's position, the district court holds that it is the substantive merits of the issue which must be independently analyzed. The rationale for the position of the district court is that the ultimate underlying question remains whether a taxpayer's method of accounting clearly reflects income. Thus, to assess the reasonableness of the Commissioner's rejection of an accounting method, it is necessary to first analyze such method on its merits as to whether it does clearly reflect income. *See, e.g.*, Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970); Artnell Co. v. Commissioner, 400 F.2d 981, 985 (7th Cir. 1968) ("there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the Commissioner rejects it"); *see also* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 533 (1979).

122. Deferral of prepaid income involves the other side of the coin of accrued expenses. Since deferral of income and accrual of future expenses are both accrual concepts, however, the reasoning and rationale are interchangeable. As such, the courts may use deferral cases to support their conclusions in accrual cases and vice versa.

123. 499 F. Supp. at 518.

124. Seago, *What Chance for Prepaid Income Deferrals Based on Statistical Estimates After RCA*, 54 J. TAX'N 16 (1981).

of the "clearly reflects income" test. Thus, it was beyond the Commissioner's discretion to disallow the method on the grounds that the method did not clearly reflect income.

The district court in RCA and other circuit courts of appeals suggest that the "clearly reflects income" standard operates independently and does not depend *solely* on the Commissioner's discretion. This interpretation is consistent with Supreme Court precedent[125] if those earlier cases are viewed as addressing the issue of *when* the Commissioner may compel the taxpayer to establish that its method of accounting "clearly reflects income" within the purview of section 446. Unless the taxpayer meets the burden of proof, the Commissioner's determination may not be overruled. Moreover, since the Court has never held that the Commissioner has absolute discretion with respect to section 446, the taxpayer may argue convincingly that a "clearly reflects income" standard exists separate and apart from the Commissioner's discretion.

b. *Relevance of GAAP*. Assuming that an independent standard of "clearly reflects income" does exist, the relationship between GAAP and the standard of "clearly reflects income" must be analyzed. Two questions must be answered: First, whether GAAP creates a presumption of validity of accounting methods for tax purposes. Second, what are the roles of the differing objectives of tax accounting and financial reporting?

In response to the argument that adherence to GAAP creates a presumption of validity of the accounting method for tax purposes, the Supreme Court has stated, "*[N]o such presumption* is present. Its existence is insupportable in light of the statute, this Court's past decisions, and the differing objectives of tax and financial accounting."[126] Taxpayers, therefore, do not receive a presumption of validity of their accounting methods for tax purposes by merely adhering to GAAP.

The divergent and often conflicting objectives of financial and tax accounting constitute the strongest argument that adherence to GAAP should not be dispositive for tax purposes. The primary goal of financial accounting is to provide useful information to

125. *See supra* notes 120-21.

126. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 540 (1979) (emphasis added). *See also* American Auto. Ass'n v. United States, 367 U.S. 687 (1961) in which the Court stated, "To say that in performing the function of business accounting the method employed by the Association 'is in accord with generally accepted commercial accounting principles and practices' it is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *Id.* at 693.

management, shareholders, creditors, and other interested parties. The major responsibility of the accountant is to protect these parties from the adverse effects of information failure.[127] Consistent with this goal, financial accounting is founded on the principle of conservatism, with the corollary that possible errors in measurement should be made in the direction of understatement rather than overstatement of net income.[128] The income tax system's primary goal is the equitable collection of revenue; the Service's major responsibility is to protect the public treasury.[129] In view of the Treasury's different goals and responsibilities, understatement of income cannot be its fundamental precept.[130]

The numerous assumptions, axioms and principles used to compute income for financial accounting and tax purposes manifest these differences in underlying rationales. Financial accounting permits estimates, probabilities, and reasonable certainties, while tax law, with its mandate to preserve revenue, cannot yield to uncertainty.[131] Thus, GAAP tolerates a range of reasonable treatments, leaving the choice among alternatives to management. Such variances, while tolerable in financial reporting, are questionable in a tax system designed to ensure that similarly situated taxpayers pay the same tax. If management's election among acceptable options were dispositive for tax purposes, a firm essentially could determine unilaterally the tax it wanted to pay, thereby making the Code unenforceable and inequitable.

A taxpayer's use of GAAP, therefore, is not and should not be dispositive as to whether an accounting method clearly reflects income. Rather, GAAP should be followed for tax purposes in circumstances where financial accounting treatment would yield a result favorable to, or consistent with, tax objectives. If the financial accounting method yields a result which is unfavorable to, or inconsistent with, tax objectives, it may be modified or altogether rejected. This interpretation of GAAP's status in relation to tax accounting concepts was articulated in *Boise Cascade Corp. v. United States*.[132] In passing on the propriety of Boise's method of deferring prepaid income, the court stated:

127. 439 U.S. at 542 (citing AICPA Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises § 171 (1970)).

128. *See supra* text accompanying note 53.

129. 439 U.S. at 542.

130. *Id.*

131. *Id.* at 543.

132. 530 F.2d 1367 (Ct. Cl. 1976).

> The taxpayer must also show that its method clearly reflects income for the purposes of the Internal Revenue Code. Thus, while generally accepted methods of accounting are of probative value and are treated with respect by Treas. Reg. § 1.446-1(a)(2), they are not necessarily synonymous with the proper tax accounting to be afforded an accrual item in a given situation.[133]

The issue then becomes what accounting methods and procedures the courts will consider consistent with tax objectives and therefore acceptable. In *American Automobile Association v. United States*,[134] the American Automobile Association (AAA) reported as gross income only that portion of the total prepaid annual membership dues actually received or collected in the calendar year. The amount of dues reported as income ratably corresponded with the number of membership months covered by those dues within the same taxable year. The Court recognized that GAAP required AAA to account for its membership dues in this manner but held that since the method of matching expenses to revenues was clearly arbitrary and based on averages and assumptions about uncertain future events, the method was not acceptable for tax purposes.[135] A GAAP accounting method will be acceptable for tax purposes where "[i]t achieves the desideratum of accurately matching costs and revenues,"[136] or if, with certainty beyond that minimum necessary for financial accounting purposes, it "allocates to each year the proper income and expense, and prevents distortion of the taxpayer's financial condition in the tax year."[137] This position was articulated in *RCA v. United States*,[138] which focused on the manner in which RCA's accounting method matched revenues and expenses in the tax year. The district court held that sufficiently precise estimates may make GAAP acceptable for tax purposes, assuming the accounting method used also clearly reflects the taxpayer's income.[139]

133. *Id.* at 1372.

134. 367 U.S. 687 (1961).

135. *Id.* at 690-93. *See* Schlude v. Commissioner, 372 U.S. 180 (1963); Automobile Club of Mich. v. Commissioner, 353 U.S. 180 (1957).

136. Boise Cascade Corp. v. United States, 530 F.2d 1367, 1377 (Ct. Cl. 1976).

137. Harrold v. Commissioner, 192 F.2d 1002, 1006 (4th Cir. 1951).

138. 499 F. Supp. 507 (S.D.N.Y. 1980), *rev'd*, 664 F.2d 881 (2d Cir. 1981).

139. *Id.* at 516-17, 524. *See* Gillis v. United States, 402 F.2d 501 (5th Cir. 1968); Pacific Grape Prod. Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955). 499 F. Supp. at 516-17. 524. In its reversal of *RCA*, the Second Circuit acknowledged that the Commissioner pressed a broad argument that accrual accounting is never permissible without express legislative authorization and the Commissioner's assent. The court, however, stopped short of blindly prohibiting all accrual accounting and stated that what offends the clear reflec-

The divergence of underlying objectives between tax and financial accounting necessitates that GAAP be probative and acceptable for tax purposes only under certain circumstances. The underlying axioms, principles, and rules used to compute income for tax purposes cannot be based on arbitrary assumptions. These assumptions must be sufficiently precise so the resulting estimate is not subject to variance dependent on the accuracy of the underlying assumptions. Finally, there is an overriding limitation that the accrual estimate must produce a result which neither contradicts nor undercuts the objectives of tax accounting.

c. *Repeal of Sections 452 and 462*. The effect of the repeal of sections 452 and 462 on the "clearly reflects income" standard becomes apparent by analyzing the sections' legislative histories. These sections were introduced as part of the general revision of the income tax laws in 1954. Congress was dissatisfied with the many divergencies which had developed between the computation of income for tax and financial reporting purposes. The differences were confined almost entirely to questions of when certain types of revenues and expenses would be accounted for in determining net income.[140] As a result, section 452 was enacted,[141] permitting an accrual basis taxpayer to defer the inclusion of prepaid income in gross income until it was earned. Section 462, enacted with section 452, permitted the current deduction of anticipated or estimated expenses by allowing reserves to be established for estimated expenses.[142] Nevertheless, due to estimated revenue

tion principle of § 446(b) is the "uncertainty inherent in [this taxpayer's] method of accounting that relies on prognostications and assumptions about the future demand for services." 664 F.2d at 888. Thus, the court does not flatly hold that all accruals and deferrals absent specific legislative authorization will be disallowed. Rather, this court found that the assumptions upon which *this particular taxpayer* (RCA) based its accrual, were too tenative and thus conflicted with tax accounting objectives. Further, the Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. at 527, has suggested that a taxpayer may justify its accrual accounting method by presenting hard evidence, including statistical evidence. *See also* Gillis v. United States, 402 F.2d 501 (5th Cir. 1968); Pacific Grape Prod. Co. v. United States, 219 F.2d 862 (9th Cir. 1955).

140. H.R. REP. No. 1337, 83d Cong., 2d Sess. 48, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4073-74.

141. Act of Aug. 16, 1954, Pub. L. No. 83-591, § 452, 68A Stat. 3, 152.

142. H.R. REP. No. 1337, 83rd Cong., 2d Sess. at 158. *See* S. REP. No. 372, 84th Cong., 1st Sess. 2, *reprinted in* 1955 U.S. CODE CONG. & AD. NEWS 2046, 2047.
Section 462 provided that: "[i]n computing taxable income for the taxable year, there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses . . . ." Act of Aug. 16, 1954, Pub. L. No. 83-591, § 462(a), 68A Stat. 3, 158. "Estimated expense" was defined as a deduction,

(A) part or all of which would . . . be required to be taken into account for a losses of one billion dollars in the first year of application and the prospective view of the administrative unworkability of the new sections,[143] Congress retroactively repealed sections 452 and 462.[144]

It is questionable whether an inference may be drawn from the repeal of these sections and subsequent congressional inaction for the past twenty-seven years. Some courts contend that congressional disapproval of all accruals and deferrals not authorized specifically by the Code can be inferred.[145] Alternatively, it can be inferred that accruals and deferrals are permissible because of congressional inaction. The middle ground between these two positions is that no inference may be drawn from the enactment and repeal of the section. Thus, accruals and deferrals are permitted or disallowed as if sections 452 and 462 never existed.

In *American Automobile Association*,[146] the Supreme Court implied that the Commissioner may reject *any* method of accounting which does not treat payments received for future services as gross income in the year of receipt. The Court based its conclusion solely on the reasoning that congressional repeal of sections 452 and 462 indicated disapproval of arbitrary estimates in computing taxable income.[147] Several lower courts, however, have refuted this inference.[148] In *Mooney Aircraft, Inc. v. United States*,[149] the court held that repeal of the two sections "[d]oes not absolutely preclude deferrals and accruals; it indicates that the Commissioner should have very broad discretion to disallow such accounting techniques when there is any reasonable basis for his action."[150] The Senate and House reports seem to support the

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> subsequent taxable year; (B) which is attributable to the income of the taxable year or prior taxable years for which an election under this section is in effect; and (C) which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy.

Id. § 462(d)(1).

143. H.R. REP. No. 293, 84th Cong., 1st Sess. 3 (1955).

144. Act of June 15, 1955, Pub. L. No. 84-73, 69 Stat. 134.

145. *See, e.g.,* Villafranca v. Commissioner, 359 F.2d 849 (6th Cir. 1966), *aff'd per curiam*, 24 T.C.M. (CCH) 1965-18; Simplified Tax Records v. Commissioner, 41 T.C. 75 (1963). Code §§ 166-167 (1976), respectively, authorize the use of estimates in computing deductions for bad debts and depreciation. *See infra* text accompanying note 146.

146. 367 U.S. 687 (1961). *See supra* text accompanying note 134.

147. 367 U.S. at 695. *See also* Schlude v. Commissioner, 372 U.S. 128, 134 (1963) (indicating that § 452 would have a disastrous impact on government revenue).

148. *See, e.g.,* Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1969); Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968); Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl. 1976), *cert. denied*, 429 U.S. 867 (1976).

149. 420 F.2d 400 (5th Cir. 1969).

150. *Id.* at 409.

Mooney holding. Congressional records indicate that the repeal was affected with an intent "to re-establish the principles of law which would have been applicable if sections 452 and 462 had never been enacted."[151] Thus, the reasonable inference to be drawn from repealing sections 452 and 462 is that Congress intended the Code to operate as if those sections never existed.[152]

In summary, the courts will find the fact that the treatment of the asserted deduction by the taxpayer clearly reflects income is relevant for all events test purposes. The clearly reflects income test is an independent test not subject solely to the Commissioner's discretion. The Commissioner, however, may impose the burden of proof upon the taxpayer to show that the accounting method used clearly reflects income. Adherence to GAAP will aid the taxpayer in carrying its burden only when the underlying objectives of tax accounting are not frustrated. Finally, neither the taxpayer nor the Commissioner is entitled to a favorable inference due to the enactment and retroactive repeal of sections 452 and 462 of the Code.

5. *Active Contest of Liability*

The fifth category that the courts examine to determine the existence of facts fixing a liability is whether the taxpayer is contesting or litigating the liability. Early case law implied that a contested liability indicated per se that all the events which fix the liability had not occurred. In *Lucas v. American Code Co.*,[153] the Court stated:

151. H.R. REP. No. 293, 84th Cong., 1st Sess. 5 (1955). *See* S. REP. No. 372, 84th Cong., 1st Sess. 5, *reprinted in* 1955 U.S. CODE CONG. & AD. NEWS 2046, 2051.

152. As previously stated, §§ 452 and 462 were repealed because of the fear of a prospective loss of revenue during the first year in which taxpayers could take advantage of the two sections. Under § 462 which was repealed in 1955, deductions could be taken in the transitional year for expenses attributable to advances taxed in prior years under a claim of right theory, as well as for reserves for future expenditures attributable to advances received and reported during that year. This procedure would give rise to a "double deduction" in the transitional year. *See* S. REP. No. 372, 84th Cong., 1st Sess. 4 (1955); H.R. REP. No. 293, 84th Cong., 1st Sess. 2-5 (1955).

Currently a large consortium of corporations is lobbying in favor of a bill which seeks to amend the Code to allow deductions for incurred but unpaid losses that the taxpayer can assert as reasonably estimable. The proposed bill differs from repealed § 462 in that it narrows the scope of the deduction. The bill would not allow a deduction for estimated and contingent expenses. The bill also contains a five year phase-in to mitigate the adverse transitional effects on federal revenues. Telephone interview with Robert Reeves, Vice President-Insurance, Hospital Corporation of America, Chairman, Captive Insurance Co. Assoc. (Jan. 7, 1981).

153. 280 U.S. 445 (1930), discussed at *supra* notes 116-17 and accompanying text.

> While the facts determining liability had occurred in the year of the breach, the amount to be recovered, if there was legal liability, depended in large part on the course of future events. . . . And, when liability is contested, the institution of a suit does not, of itself, create certainty of loss.[154]

In *Dixie Pine Products Co. v. Commissioner*,[155] the Court reaffirmed the principle that all the events have not occurred in the tax year to fix the amount and fact of liability when the liability is contingent and contested by the taxpayer.[156] In *Dixie Pine*, Mississippi assessed and collected a gasoline tax from the taxpayer in 1936. Dixie Pine subsequently filed suit to recover the tax paid on the basis that it was exempt from such taxation. In 1937, Dixie Pine accrued and deducted, but did not actually pay, an amount for the gasoline tax while still contesting the liability. The Court held that the taxpayer was not entitled to the 1937 deduction and only could claim a deduction for the taxable year in which the liability was finally adjudicated.[157] Notably, the Court did not question the validity of the 1936 deduction which was actually paid but nevertheless still being litigated. The Court only disallowed the *accrued* deduction currently being litigated.

The Supreme Court has gone even further than *Dixie Pine* with respect to contested liabilities. In *United States v. Consolidated Edison Co.*,[158] the taxpayer paid a property tax and interest penalty to New York City to avoid property seizure while contesting the legality of the tax. The Court held the taxpayer could not even deduct the *paid* portion of the tax during the contest as it was more a deposit than an expense.[159] To alleviate the harshness

154. 280 U.S. at 450-51.

155. 320 U.S. 516 (1944).

156. *Id.* at 519.

157. *Id. See* Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944), where petitioner paid $93,000 in 1935 in federal processing taxes and accrued and deducted $10,000 more while contesting the constitutionality of the tax. Citing *Dixie Pine* as controlling, the Court held that the petitioner was not in a position to treat the $10,000 as an accrued liability because it denied liability for the tax and failed to pay the accrued portion during 1935. The Court, however, allowed the deduction for the $93,000 *paid*, notwithstanding the petitioner's contest of that portion of the liability. The Court stated, "The amount thus paid is not involved [in this dispute]." *Id.* at 282.

158. 366 U.S. 380 (1961).

159. The Court stated:

> "Payment" is not a talismanic word. It may have many meanings depending on the sense and context in which it is used. . . . "A payment may constitute a capital expenditure, an exchange of assets, a prepaid expense, *a deposit*, or a current expense" and "[w]hen the exact nature of the payment is not immediately ascertainable because it depends on some future event, such as the outcome of litigation, its treatment for income tax purposes must await that event."

of *Consolidated Edison* and to restore the narrow exception of deductibility for paid portions of contested liabilities, Congress enacted section 461(f) as an amendment to the Internal Revenue Code of 1954.[160] Although the statute was designed to reverse the effects of *Consolidated Edison* by allowing a deduction for contested liabilities actually paid by the taxpayer, the Regulations[161] and subsequent judicial interpretation[162] have greatly narrowed its practical use. A taxpayer seeking the deduction, for example, must place an amount of money equalling the total potential liability beyond his or her control and relinquish authority over it.[163] Additionally, if the taxpayer wants to use a trust vehicle to establish the reserve, the consent of the claimant first must be obtained.[164]

Thus, *Consolidated Edison* has removed the narrow exception allowing taxpayers to deduct disputed liabilities which were paid. Deductions for liabilities being litigated or contested will be disal-

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Id. at 391 (quoting Consolidated Edison Co. v. United States, 279 F.2d 152, 156 (2d Cir. 1960)).

160. Act of Feb. 26, 1964, Pub. L. No. 88-272, § 223(a)(1), 78 Stat. 19, 76 (codified at I.R.C. § 461(f) (1976)) provides:

> If — (1) the taxpayer contests an asserted liability, (2) the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability, (3) the contest with respect to the asserted liability exists after the time of the transfer, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for an earlier taxable year), then the deduction shall be allowed for the taxable year of the transfer.

161. Treas. Reg. § 1.461-2(c)(1) (1964) provides in relevant part:

> A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or the property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or . . . to a court with jurisdiction over the contest.

162. *See, e.g.*, Poirier & McLane Corp. v. Commissioner, 547 F.2d 161 (2d Cir. 1976). The taxpayer, a contractor, was sued by property owners adjacent to construction sites. The taxpayer, aware that its insurance did not cover liability for trespass, established a reserve to cover the estimated value of the claims. Pursuant to this plan, the taxpayer deposited $1.1 million of securities into an irrevocable trust. The balance was to be returned to the taxpayer upon the disposition of the trespass claims. The court noted that § 461(f) was to be construed narrowly to forestall potential abuses and held the mere transfer of funds was insufficient to establish the fact and amount of the liability. If it were otherwise, the taxpayer could unilaterally "manufacture" a deduction not realistically matching receipts and disbursements for specific taxable years. Thus, the essential requirement for deduction which is absent in this case is claimants' agreement to the establishment of the trust. The rationale is that the agreement is, in effect, the equivalent of a direct payment of the asserted claim. It fixes the fact and amount of the liability.

163. Treas. Reg. § 1.461-2(c)(1)(iii) (1964).

164. 547 F.2d at 167.

lowed, even when the taxpayer has paid the disputed liability, unless the requirements of section 461(f) are met. Due to the administrative burdens on the taxpayer, however, the relief provisions of section 461(f) basically are unavailable.

6. *Conditions Precedent Versus Conditions Subsequent*

The character of certain contingencies surrounding facts which give rise to liability may impact on the fixation of liability for tax purposes. If the contingent event is a condition precedent to the liability, this fact indicates that all the events which fix liability have not occurred. If, however, the contingent event is a condition subsequent to the liability, then sufficient facts exist to fix the liability and only the amount and/or certainty of the payment, rather than imposition of liability is at issue. Thus, existence of an unfulfilled condition precedent precludes liability.[165] Existence of a condition subsequent goes to the certainty of payment, the second prong of the all events test. An unfulfilled condition subsequent has no effect on whether a liability is fixed.[166]

If a condition precedent fails to occur, an obligation to pay will never arise.[167] A condition precedent, defined by what a claimant needs to show to establish liability, is an event which must occur to perfect a right in the claimant.[168] Such a condition is a fact other than mere lapse of time which must exist or occur before a duty of immediate performance of a promise arises.[169]

A condition subsequent, if fulfilled, might diminish or terminate an *existing* liability.[170] An expense item accrues when the fixed obligation is incurred even though the amount is not presently due or may be diminished by subsequent events.[171] Thus, while the existence of an absolute liability is required for a permissible deduction, absolute certainty that it will be paid is not so required.[172] The distinction between precedent and subsequent is

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165. World Airways v. Commissioner, 62 T.C. 786, 804 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

166. *Id.* at 803.

167. *Id.* at 804.

168. *See* Lawyers' Title Guar. Fund v. United States, 508 F.2d 1 (5th Cir. 1975).

169. United States v. Schaeffer, 319 F.2d 907, 911 (9th Cir. 1963).

170. 62 T.C. at 803.

171. Ohmer Register Co. v. Commissioner, 131 F.2d 682, 686 (6th Cir. 1942).

172. Spring City Co. v. Commissioner, 292 U.S. 182 (1934). *See* Helvering v. Russian Fin. & Constr. Corp., 77 F.2d 324, 327 (2d Cir. 1935) ("[t]hat the liability may not subsequently be discharged by payment does not necessarily prevent its consideration as a liability for the years accrued").

that the former goes to the issue of fixing the liability itself, while the latter goes to the issue of certainty of payment or amount eventually paid.

The issue when using a condition precedent versus a condition subsequent to determine if a liability is fixed is whether a contingent event is precedent or subsequent to the liability. In *World Airways v. Commissioner*,[173] the taxpayer had contracted with a commercial airline to have its aircraft periodically serviced. The court held that a condition precedent existed because petitioner could not be bankrupt at the time of service and the aircraft had to be in existence when the service was performed. The occurrence of an air crash, permanent grounding, retirement of the aircraft, or bankruptcy of the taxpayer would prevent the maintenance obligation from arising.[174] Thus, the court disallowed accrual of the maintenance costs as a result of these conditions precedent to taxpayer's liability.[175]

In *W.S. Badcock Corp. v. Commissioner*,[176] the taxpayer, a furniture manufacturer, regularly had consigned furniture to dealers under contracts entitling them to commissions upon sale of the furniture. No commission was due and payable, however, until the dealer collected the sales price and remitted it to Badcock. Badcock, an accrual basis taxpayer, reported the full sales price as income in the year of sale. The corporation also claimed the total sales commissions as deductions before collecting payment from the dealer and paying the commissions. In upholding the taxpayer's accounting method, the court stated that risk of noncollection (by the dealer) in a credit transaction was not a condition defeating fixed liability. The commissions, though *payable* only upon collection of the sales price, were incurred and became fixed liabilities within the taxable year of sale.[177]

Another contractual situation in which the court found a condition subsequent did not defeat liability, was present in *Helvering v. Russian Finance & Construction Corp.*[178] The taxpayer, a domestic corporation, contracted with an association of manganese producers and the Soviet government to purchase 600,000 tons of

173. 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1978).

174. *Id.* at 804.

175. *Id.*

176. 491 F.2d 1226 (5th Cir. 1974).

177. *Id.* at 1229. *See* Ohmer Register Co. v. Commissioner, 131 F.2d 682 (6th Cir. 1942) (fixed but unpaid sales commissions payable only upon collection of sales price held accruable expense deductions).

178. 77 F.2d 324 (2d Cir. 1935).

ore at market price and pay an additional two dollars per ton at the end of ten years from the date of the agreement. The agreement discharged the taxpayer of any obligation to pay the additional two dollars per ton upon mutual termination of the continuing supply and purchase agreement, breach by the Soviet government, or the occurrence of strikes seriously handicapping the producers' ability to supply ore. The taxpayer ratably accrued and deducted the two dollars per ton as the ore was received. The court held that the liability arose upon delivery of the ore. Even though the liability might never be paid, an enforceable obligation existed upon receipt of the ore. The additional two dollars per ton constituted part of the ore's cost and was accrued properly on receipt of the ore.

The pattern in *Russian Finance* indicates a condition subsequent. Where a service has been rendered to the taxpayer, payment has been earned by the creditor, and only facts relating to amount and time of payment remain to be determined, courts will usually find a condition subsequent. Alternatively, a typical condition precedent is evidenced by an executory contract. The creditor has not performed the service and must wait for conditions to occur before performing its contractual obligation and thereby obligating the taxpayer to its claim.

The analysis thus far has considered six factors courts have used to test whether the first part of the all events test—whether sufficient facts have occurred to fix the liability for federal income tax purposes—has been fulfilled. These six factors[179] are not mutually exclusive. Several factors may apply in a single case. Courts also have not considered any one factor as more dispositive than another. Many courts, however, focus on one or two factors and then render an opinion based on analysis of only the few factors examined. When a court does find sufficient facts to fix liability, it will then examine the second part of the all events test—whether the liability amount can be determined reasonably

179. To summarize, the six factors which have been discussed are:

(1) Whether there is a statutorily fixed obligation;
(2) Whether there is a contractually fixed obligation;
(3) Whether liquidation of the liability is near or remote in time;
(4) Whether the accrual accounting system in issue clearly reflects income for tax purposes;
(5) Whether the taxpayer is contesting the existence of the liability through litigation or otherwise; and
(6) Whether facts triggering liability are conditions precedent or conditions subsequent to facts establishing liability.

accurately.[180]

B. *Amount of Liability Reasonably Ascertainable*

As early as *United States v. Anderson*,[181] when the Supreme Court created the all events test, the issue was raised of whether an expense could be accrued when the exact amount was unknown. If this issue were resolved affirmatively, then a subsidiary issue would be raised concerning the required degree of certainty or accuracy as to this amount. In 1929, in *Lucas v. American Code Co.*,[182] the Court implied in dictum that only a reasonable estimate of loss was necessary to satisfy the second part of the all events test.[183] Reasonableness was assessed by relating the computation of the reserve to the loss.[184]

In *Uncasville Manufacturing Co. v. Commissioner*,[185] the Court of Appeals for the Second Circuit summarized the common law position on the degree of reasonableness necessary to satisfy this second part of the all events test. In *Uncasville*, the taxpayer's taxable income for 1918 was increased after an audit by the Service. The increase caused a concomitant state income tax adjustment since the state tax was based on federal taxable income. The question was whether the additional state tax would be allowable as a deduction against federal taxable income in 1918, the year to which the state tax applied, or in 1925, the year in which the deficiency was assessed. The court held that 1918 was the proper year of deduction: "All the facts upon which the calculation depended had been fixed before the expiration of the year 1918. . . . The computation was uncertain, but its basis was unchangeable; it was unknown, not unknowable at December 31, 1918."[186]

Thus, for a taxpayer to accrue an item of expense, the liability amount computable only must be reasonably, but not exactly estimable at the end of the taxable year. Problematically, the courts never have articulated a clear definition of "reasonable accuracy." Some decisions indicate that greater emphasis will be placed on the method by which a taxpayer has computed the expense rather than on a comparison between the estimated amount and the sub-

180. *See* Treas. Reg. § 1.461-1(a)(2) (1957).
181. 269 U.S. 422 (1926). *See supra* note 70 and accompanying text.
182. 280 U.S. 445 (1929). *See supra* note 116 and accompanying text.
183. 280 U.S. at 451.
184. *Id.* at 451-52.
185. 55 F.2d 893 (2d Cir. 1932).
186. *Id.* at 895.

sequently determined actual expense. If the court determines that proper information was not used or improper assumptions were made in computing the liability, a disallowance of the accrual results, regardless of the estimate's accuracy.[187]

Courts generally have required evidence of the use of one of two methods to compute the accrual within reasonableness guidelines. The strict and inflexible standard requires a fixed date for future payments. The newer and more flexible standard allows the use of statistics, the law of large numbers, and estimates based on prior experience *if* the method properly matched income and expenses for tax accounting purposes.[188]

The strict standard was established in *Brown v. Helvering*.[189] The taxpayer sold several fire insurance policies and attempted to deduct an estimated accrual representing lost commissions due to cancelled policies. The taxpayer was unable, and did not attempt, to identify which particular policies would be cancelled before expiration. The taxpayer attempted to deduct the accrual by estimating the average effect on all the policies. The Court implicitly rejected the taxpayer's use of aggregate estimates, stating that insurance companies are permitted to analyze their operations on a group basis only because of specific statutory authorization.[190] The Court also stated that the taxpayer's method of computing his estimate based on aggregate experience did not reflect the expense with reasonable certainty.[191] This determination may leave the door open for other courts to imply that the flexible standard is consistent with *Brown* if estimates based on aggregate experience

187. *See* Denise Coal Co. v. Commissioner, 271 F.2d 930 (3d Cir. 1959), *discussed in supra* notes 80-86 and accompanying text. In considering the issue of the accuracy of the cost of backfilling the stripmine, the court was impressed with Denise's use of independent engineers, contractors, and accountants to scientifically arrive at an estimate. Concluding that the estimation process was reasonable, the court allowed current deduction of accrual despite the estimate being more than a 100% overstatement of actual subsequent cost. *Cf.* Chicago, Burlington & Quincy R.R. v. United States, 455 F.2d 993 (Ct. Cl. 1972), *rev'd on other grounds*, 412 U.S. 401 (1973). The Court of Claims disallowed an accrual of vacation pay that varied only 5.3% from actual cost. The railroad had possessed data which the court thought more reliable than that used to compute the vacation pay accrual. The court, therefore, did not sanction the method used to compute the accrual. *See generally* Hawekotte, *How "All Events" Test for Deduction of Accrued Expenses is Presently Being Applied*, 21 TAX ACCT. 26 (1978).

188. *See supra* notes 112-52 and accompanying text.

189. 291 U.S. 193 (1934).

190. *Id.* at 201. For the present treatment of insurance company taxation, see I.R.C. §§ 801-841 (1976) (Subchapter L).

191. *Id.*

are sufficiently precise.[192]

The district court in *RCA v. Commissioner*[193] seized the opportunity to hold that a deferral based on sufficiently precise estimates using statistical analysis fits within the standard of *Brown*. The court distinguished the familiar trilogy of *American Automobile Association v. United States*,[194] *Automobile Club of Michigan v. Commissioner*,[195] and *Schlude v. Commissioner*[196] based on the extraordinary accuracy with which the taxpayer, RCA, computed its income deferral. The court then held that a taxpayer is entitled to utilize reliable statistical projections of anticipated expenses in determining the extent to which prepaid amounts should be included in gross income in tax years other than the year of receipt. The proper test is whether use of statistical estimates assures accurate matching of expenses to related revenue in the taxable year. The court in *RCA* interpreted the holdings of *American Automobile Association* and *Automobile Club of Michigan* as merely requiring that the taxpayer's method of accounting meet a heavy burden of proof that any income deferred will be earned actually in the future. The AAA and Automobile Club of Michigan failed to meet this burden, not because they used estimates, but because of the arbitrariness of the method used in computing such estimates.[197] The court in *RCA* held that the taxpayer's method of accounting for advance payments in *Schlude* was found " 'artificial,' and therefore impermissible," because "services [were] to be performed 'only upon customers' demand without relation to fixed dates in the future.' "[198] The problem was not that the *time* of performance was unspecified, but rather that the extent of performance was unspecified. Consequently, there was no assurance

192. *Cf.* Milwaukee & Suburban Transport Corp. v. Commissioner, 18 T.C.M. (CCH) 1039 (1959), *rev'd*, 283 F.2d 279 (7th Cir. 1960), *vacated per curiam*, 367 U.S. 906 (1961), *aff'd*, 293 F.2d 628 (7th Cir. 1961), *cert. denied*, 368 U.S. 976 (1962) (where the taxpayer was entitled to deduct certain amounts accrued on its books as estimates of sums it would have to pay in settlements of personal injury and property claims).

193. 499 F. Supp. 507 (S.D.N.Y. 1980).

194. 367 U.S. 687 (1961). For a discussion of *AAA*, see *supra* text accompanying notes 134 & 146–47.

195. 353 U.S. 180 (1957).

196. 372 U.S. 128 (1963). In *Schlude*, the taxpayer, a dance studio operator, required students to sign contracts providing for advance payment for all lessons given on installment payments no matter when or whether the student actually took the lessons. The Court held that the taxpayer could not defer prepaid income for the portion of the contract price attributable to lessons not yet given in the current tax year because contingencies were likely to occur such as students letting contract rights expire before lessons.

197. *See* 367 U.S. at 693-94; 353 U.S. at 189.

198. 499 F. Supp. at 515 (quoting Schlude v. Commissioner, 372 U.S. 128 (1963)).

that the accounting method employed would accurately match revenues and related expenses.[199]

All that *Schlude* and *AAA* require is the reporting of deferred income concurrently with the occurrence of the related expenses.[200] Thus, it appears that the essence of the second part of the all events test—reasonable estimation of the expense—is heavily dependent on the first part of the test—facts evincing a fixed liability. The overall issue, therefore, is whether, within defined tax objectives, the taxpayer's accounting method accurately matches expenses to income in the current taxable year. If the taxpayer's accounting method clearly reflects income within the tax meaning of the phrase, then a fortiori, all the events which fix liability have occurred, and the method used to compute the deferral or accrual is reasonable. Thus, the essence of the all events test is properly identifying constraints placed on accounting systems in which financial accounting objectives differ from tax objectives.

Once the essence of the all events test is analyzed and developed, it can be applied to estimated accruals of reserves for workers' compensation losses. The following section presents the Service's position and early case law on this topic. The analyses of the few modern cases which have passed on the issue of deductibility of these reserves then are examined. Finally, the all events test, as developed in this section, is applied to the workers' compensation accrual situation.

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199. *Id.* at 514. *See* Schlude v. Commissioner, 372 U.S. at 142 (Stewart J., dissenting). Justice Stewart noted that the majority's reference to "estimated cancellations" as the cure for the defect (in taxpayer's "arbitrary" accounting method) dispelled any suggestion that the broad but cryptic language used by the Court in *American Automobile Association* was intended to bar use of statistical projections, provided that they were supported adequately.

200. *See* Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 407-08 (5th Cir. 1969). In Pacific Grape Prods. Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955), taxpayer attempted to accrue as an expense the costs of canning, labeling, packing, and shipping for fruit sold but not yet prepared. The Court stated:

> Not only do we have here a system of accounting which for years has been adopted and carried into effect by substantially all members of a large industry, but the system is one which appeals to us as so much in line with plain common sense that we are at a loss to understand what could have prompted the Commissioner to disapprove it. Contrary to his suggestion that petitioner's method did not reflect its true income it seems to us that the alterations demanded by the Commissioner would wholly distort that income.

Id. at 869.

IV. Federal Income Tax Treatment of Reserves for Workers' Compensation

The current position of the Service is identical to that taken by the early courts passing on the deductibility of self-insurance and workers' compensation accruals. The Service contends that taxpayers may not deduct the reserves that they establish to pay for unknown losses. Although the taxpayer will get a deduction for these losses when they become "fixed and determinable," only after-tax dollars will be available to invest toward payment of these losses until that time. The Service's position is paradoxical because if the taxpayer had *purchased* insurance, the premiums paid would be deductible. Under the authority of Subchapter L of the Code,[201] however, the commercial insurance company would have been able to establish a deductible reserve computed on an aggregate of claims experience basis. The self-insured taxpayer thus is forced to absorb the loss until it is actually payable, at which time the taxpayer receives the deduction. An insurance company, however, is permitted to deduct the potential losses based on estimates. The common law derivation of the Service's position is presented in the next section.

A. *Early Case Law*

This inflexible position concerning deductions for self-insurance reserves has its roots in two early Board of Tax Appeals cases. In *Pan-American Hide Co.*,[202] the taxpayer established a reserve for an amount equal to the premiums which would have been paid had fidelity insurance been obtained. The court held that the reserve, unlike depreciation, was not authorized specifically in the Code. Additionally, the reserve was not deductible as an insurance premium because there was no risk shifting.[203]

The deductibility of self-insurance reserves for workers' compensation losses was first addressed by the Board of Tax Appeals

201. I.R.C. §§ 801-841 (1976).

202. 1 B.T.A. 1249 (1925).

203. *Id.* at 1250. For two recent cases in which taxpayers unsuccessfully argued that the deduction for contributions to the reserve account was based on the theory of the contribution as an insurance premium, see Steere Tank Lines, Inc. v. United States, 577 F.2d 279 (5th Cir. 1978); Carnation Co. v. Commissioner, 71 T.C. 400 (1978). Both the Service and the courts view the taxpayers' theory as problematic because an insurance premium must transfer risk of loss to an unrelated insurer. Self-insurance fails to qualify as insurance because no risk is transferred to an unrelated entity. Risk of loss remains with the self-insurer.

in *Spring Canyon Coal Co. v. Commissioner*.[204] Pursuant to a Utah workers' compensation law, the taxpayer elected to self-insure and established an independent operation to administer claims.[205] The operation was funded by the taxpayer with an amount equal to the premium which would have been paid had insurance from the state fund been purchased.[206] The fund's size also was monitored by the Industrial Commission of Utah.[207] As a result, the taxpayer contended that it should have been permitted to accrue, for income tax purposes, the payments made to the fund. The court flatly asserted that "the amount of the reserve does not constitute an ordinary and necessary business expense and is, therefore, not deductible."[208] The opinon focused on the deductibility of these payments under the theory that they constituted payments to a bona fide trust. The all events test was ignored completely.[209]

Some modern courts have taken these sparsely reasoned cases to establish "an essentially unqualified principle that self-insurance reserves are not deductible for income tax purposes."[210] This principle appears to remain intact even when the contributions are equivalent to arm's-length premiums, ordinary insurance is unavailable, and reserves are established pursuant to state insurance commissioner guidelines. When developing this prohibition, the Board of Tax Appeals did not analyze these cases under the rationale of the all events test. Furthermore, the Board did not inquire whether the liability had been accepted for cases unsettled at the year's end or where claims were fixed but uncontested. This early case law position is inflexible and unresponsive to the exigencies of modern corporate risk management. Several recent decisions, however, have created cracks in this traditional (though

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204. 13 B.T.A. 189 (1928), *appeal denied*, 43 F.2d 78 (10th Cir. 1930), *cert. denied*, 284 U.S. 654 (1931).

205. *Id.* at 190-91.

206. *Id.* at 191.

207. *Id.* at 194.

208. *Id.* at 195.

209. The court rejected the argument that Spring Canyon had established a bona fide trust. Nevertheless, it implicitly accepted the proposition that had the taxpayer successfully established a trust pursuant to trust law rules, the payments to the trust would be deductible. *See* Hibbard, Spencer, Bartlett & Co., 5 B.T.A. 464 (1926). The court specifically rejected the taxpayer's arguments that the payments constituted insurance premiums and that the taxpayer was in effect an insurer and able to utilize the favorable aggregate estimation for the loss provisions of subchapter L. 13 B.T.A. at 195-96, 199-201.

210. Note, *Federal Taxation Concepts in Corporate Risk Assumption: Self-Insurance, the Trust, and the Captive Insurance Company*, 46 FORDHAM L. REV. 781, 805 (1978).

questionable) barrier.[211]

B. *Modern Case Law*

In *Thriftimart, Inc. v. Commissioner*,[212] the taxpayer was self-insured for workers' compensation under California law. The law required the taxpayer to post a surety bond for 125 percent of the reserve account for workers' compensation losses. Both taxpayer's reserve account and claims administration were handled by an independent insurance management firm which computed estimates of losses on an individual claim basis. Nonetheless, the Commissioner contended, and the court agreed, that the portion of the accrual representing losses payable in the future was not deductible until paid. Accordingly, that portion of the accrual which contained a provision for contested losses under the authority of *Dixie Pine v. Commissioner*[213] was disallowed.[214] Furthermore, since the taxpayer was not liable until an injured employee actually incurred medical expenses or was absent from work for more than seven days, the court disallowed petitioner's accrual which contained estimates for claims before these conditions were satisfied.[215]

In analyzing the taxpayer's accrual, the court did not separate contested claims and claims for which liability had not yet been fixed under California law from claims where the petitioner had admitted liability and the statutory conditions imposing liability had occurred. The court ignored the existence of taxpayer's claims which were not subject to the conditions preventing imposition of statutory liability. The court, instead, stated that claims which satisfied all the statutory conditions were "subject to the contingencies of a preexisting malady, doubtful or imprecise medical diagnosis, development of medical complications or changed conditions."[216] The court confused the events fixing the liability with conditions bearing on the liability amount. The court also interpreted events which normally identify the existence of a condition subsequent to be indicative of a condition precedent.[217]

211. *See id.* at 805-07.

212. 59 T.C. 598 (1973).

213. 320 U.S. 516 (1944). For a discussion of *Dixie Pine*, see *supra* notes 155-57 and accompanying text.

214. 59 T.C. at 607.

215. *Id.* at 608.

216. *Id.* at 609.

217. Conditions subsequent and conditions precedent are discussed at *supra* notes 165-80 and accompanying text.

Thus, the court erred by characterizing facts which affect the *amount* of the liability as facts which affect the *actual existence* of the liability.

The deficiencies in the *Thriftimart* opinion were identified in *Crescent Wharf & Warehouse Co. v. Commissioner*.[218] The taxpayer, a California corporation, established a reserve account for accrued workers' compensation losses. The same independent insurance management firm as in *Thriftimart* administered the account and calculated claims on an individual basis. Taxpayer's accrual, however, excluded all reserves for contested claims. The court held that the injury itself, if uncontested by the employer, establishes liability under the California statute and implicitly establishes liability in a no-fault situation in which the employer does not contest that the injury was employment related. *Thriftimart* was distinguished on the basis that there were contingencies, such as imprecise medical diagnoses and medical complications, which confused the issue of fixing the liability with reasonable estimation of the amount. The crucial aspect of the opinion in *Crescent Wharf* is that the injury itself is sufficient to establish the facts fixing liability.[219]

The same tax court which decided *Thriftimart* subsequently followed *Crescent Wharf* in *Wien Consolidated Airlines v. Commissioner*.[220] In *Wien*, the petitioner's accrual was for the present value of death claim benefits to the wives and children of three of its pilots killed in the scope of employment. Under Alaska law, strict liability is imposed on the employer at the time of the employee's death in a work-related accident. The petitioner did not contest liability and the court found that facts fixing liability had occurred upon the pilots' deaths.[221] Since the contingencies of the possible remarriage of the wives or the death of the children before expiration of the statutory benefits were of such a nature that the pre-existing liability might be terminated, they were

218. 59 T.C. 751 (1973), *rev'd*, 518 F.2d 772 (9th Cir. 1975).

219. 518 F.2d at 775. The Court of Appeals, however, remanded the case to the trial court to rule on whether the method of computation yielded a reasonable estimate of the loss. Crescent Wharf agreed on remand that it was not entitled to an accrual for 1964 and 1965 since it could not locate records necessary to identify the cases remaining uncontested at the end of those two years. The company could identify the uncontested cases as of December 31, 1966. Since the accrual was proven to be quite accurate, as evidenced by subsequent payouts on these cases, a deduction was allowed for the accrual as of that date and judgment was entered in the Tax Court pursuant to a stipulation. See Hawekotte, *supra* note 187, at 31.

220. 60 T.C. 13 (1973), *aff'd*, 528 F.2d 735 (9th Cir. 1976).

221. *Id.* at 15.

deemed conditions subsequent and not conditions precedent.[222] *Thriftimart* was distinguished by examining the relevant statutes. Under California's workers' compensation statutes, liability is not fixed until medical services are rendered or the employee is absent from work for seven days. In Alaska, however, liability fixes upon injury.[223] In assessing the reasonable estimation of the liability, the court stated: "[I]f a condition subsequent is unlikely to occur, its existence will not prevent the amount of a liability from being reasonably certain."[224]

The Service has indicated the reasoning of *Crescent Wharf* and *Wien* will not be followed, and the issue of accrual for self-insurance reserves for workers' compensation losses will be litigated.[225] The Service maintains that the mandate of *Brown v. Helvering*[226] and subsequent case law prohibits accruals and deferrals based on estimates not authorized by statute.[227]

C. *Accrual of Workers' Compensation Losses Under the All Events Test*

The analysis in *Crescent Wharf* and *Wien* is helpful but incomplete. Accrual of reserves for workers' compensation losses is part of the bigger issue of the deductibility of reserves in general under the all events test. The facts and exigencies of an accrual must be viewed in light of the concepts developed in part III above as to whether a particular transaction qualifies for accrual and deduction under the all events test.

1. *Facts Fixing Liability*

The first part of the all events test is satisfied if a statute operates to fix the obligation upon occurrence of all the operative facts necessary to trigger liability.[228] The Service has acquiesced on this point. The issue becomes whether all the operative facts have occurred to trigger a statute's operation to fix liability, not whether

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222. *Id.*

223. *Id.* at 16.

224. *Id.* at 17. Thus, the court finally held, and the Court of Appeals agreed, that since there was a 97% actuarial chance that the children would live to age 19, accrual for benefits to be paid to them was permissible. With respect to accruals for the widows, since petitioner's estimate did not take a remarriage factor into account, these accruals were considered unreasonable and were disallowed. 528 F.2d at 738.

225. Rev. Rul. 80-191, 1980-2 C.B. 168; Rev. Rul. 70-262, 1970-1 C.B. 122.

226. 291 U.S. 193 (1934). *See supra* notes 189-91 and accompanying text.

227. *See, e.g.*, I.R.C. § 166 (1976) (bad debts); *id.* § 167 (depreciation).

228. *See supra* notes 80-91 and accompanying text.

it is applicable to fix liability. *Crescent Wharf* and *Wien* established that it is the injury itself which fixes liability in a no-fault situation. This conclusion implies that the only operative fact necessary to trigger liability is the injury of the employee while acting within the course and scope of employment. The Service might argue, as it did in *Thriftimart*, that there are additional operative facts which cannot be accounted for and must be determined before *all* operative facts can be said to have occurred. As stated earlier, the Service is confusing facts which *impose* or *fix* liability with those bearing on the *extent* of the liability. With an unconditional no-fault statute, the better reasoned position is that the operative facts occur and liability becomes fixed when the injury arises within the course and scope of employment and the employer chooses not to contest the claim on the scope of employment issue.

The Service and the courts agree that in some circumstances, a contractual arrangement may give rise to an accrual deduction.[229] Although the basis of workers' compensation obligations is statutory, contract litigation provides a useful analogue to the determination of liability on an aggregate basis. Most courts seem to hold that the crux of the all events test is certainty of liability or creation of an enforceable liability and not whether a liability is established to any particular person. These cases, however, involve profit-sharing, SUB, and unemployment funds which by their nature establish a liability to a group which is apportioned among qualifying individuals.[230] A workers' compensation accrual estimated on an aggregate basis presents the reverse situation. This estimate starts with liability to an individual and then attempts to estimate the liability to individuals using aggregate or group experience. Thus, using these cases to argue this liability to individuals is not likely to be met with much success.

The Service often cites *Mooney Aircraft*[231] for the proposition that uncertainty of time of payment establishes that a fixed liability does not exist.[232] *Mooney Aircraft* is distinguishable because it involved payments which were not to begin until the aircraft was retired. Payment pursuant to a workers' compensation claim begins immediately and continues for as long as the statute requires.

229. *See supra* notes 92-105 and accompanying text.

230. *See supra* notes 76-89 and accompanying text.

231. 420 F.2d 400 (5th Cir. 1970). See *supra* notes 130-31 and accompanying text for a discussion of *Mooney Aircraft*.

232. *See supra* notes 108-11 and accompanying text.

Despite the immediacy of the payment stream, the concurrence in *Lukens Steel*[233] reasoned that the speculative nature of the future commencement of payment was insufficient by itself to prevent fixing of liability. Since payment starts immediately in a workers' compensation claim, the Service's argument in *Mooney* is undercut.

Another argument which a taxpayer may advance to establish the propriety of an accrual for a workers' compensation claim is that the accrual "clearly reflects income" for tax purposes.[234] Additionally, adherence to GAAP will be probative when the taxpayer's financial reporting method does not interfere with tax accounting objectives. Accrual for the estimated present value of a claim, therefore, is in accordance with GAAP. Use of precise actuarial estimates for such an accrual will result in accurate matching of revenues and expenses—the underlying objective of tax accounting. Disallowance of the accrual would put the taxpayer on an accrual basis for income generated through uncollected sales revenues while placing the taxpayer on a cash basis for deductibility of expenses associated with generation of this income. The result is an obvious mismatching of revenues and expenses.

The Service further argues that despite the necessity of an accrual, it cannot be allowed if its computational base is arbitrary, insufficiently precise, or subject to variation. Such an accrual would allow the taxpayer to unilaterally choose its tax liability. Inconsistent and inequitable administration of the tax law would result. The taxpayer may counterargue, however, that fixing of payment dates and amounts by state law removes the arbitrariness from the accrual. Precision is achieved by considering these predetermined amounts in light of the time value of money and revision due to actuarial changes in the life of the claim recipient. Use of an independent claims administrator and an actuary serves to objectify the estimates. The taxpayer may argue confidently that its actuarial estimate based on these rigidly fixed payment schedules makes an accrual precise and lacks arbitrariness. Revenues are properly matched with expenses, tax accounting objectives are not interferred with, and income is clearly reflected. Adherence to (GAAP) is additional probative evidence that accrual is proper.

Active contest of facts fixing liability will lead to disallowance

233. 442 F.2d 1131 (3d Cir. 1971). *See supra* notes 106-07 and accompanying text.
234. *See supra* notes 112-52 and accompanying text.

of the accrual.[235] This principle is well established, subject only to the exception of section 461(f) of the Code allowing accrual of a contested liability in limited circumstances.[236]

The final mode of analysis courts use to determine whether all facts have occurred fixing liability is the examination of the distinction between conditions precedent and subsequent.[237] A condition precedent prevents liability from emerging while a condition subsequent diminishes, modifies, or terminates an existing liability. The Tax Court and the Court of Appeals for the Ninth Circuit agreed that employment-related injury was the *only* condition precedent to liability under the Alaska and California workers' compensation statutes. The exigencies of payment, such as imprecise medical diagnoses, medical complications, and changing life expectancies of beneficiaries are all conditions subsequent which merely modify or terminate existing liability. The injury fixes liability and changing conditions bear only on amount and timing of payment.

2. *Reasonableness of Amount*

Once facts fixing liability have occurred, the second requirement of the all events test becomes applicable. The accrual must be a reasonable estimate, but not precisely correct.[238] The standards by which reasonableness is judged vary between the courts and the Service.

The courts generally examine the method used to calculate the estimate in determining its reasonableness. The Service, however, generally posits that reasonableness requires fixed dates and amounts for future payments. Taxpayers have argued successfully that fixed dates are not required and that statistics and the law of large numbers may be used to calculate estimates for accrual. An accrual for workers' compensation falls somewhere between these extremes. This accrual fulfills the Service's requirements since amounts and dates of payment generally are fixed by state statute and are dependent only on the nature of the injury. The workers' compensation accrual is similar to the use of purely statistical bases for accrual because it involves the use of actuarial estimates to generate the present value of an individual claim.

235. *See supra* notes 153-64 and accompanying text.
236. *See supra* notes 160-64 and accompanying text.
237. *See supra* notes 165-80 and accompanying text.
238. *See supra* notes 181-99 and accompanying text.

The Service's position is founded on an outdated interpretation of the inflexible *Brown v. Helvering*[239] doctrine. The newer and more flexible position espoused by the taxpayers in *Crescent Wharf* and *Wien* is the better reasoned view. Use of statistical estimates, group experience, and the law of large numbers should be permissible when they are sufficiently precise, not arbitrary, and do not result in undermining tax accounting objectives. The essence of the reasonableness requirement, therefore, is actually subsumed by that part of the all events test which permits an accounting method for tax purposes which clearly reflects income. Thus, when a taxpayer's semifixed estimate based on actuarial techniques is found to be an accounting method which clearly reflects income, it follows a fortiori that the method will have been calculated with sufficient reasonable precision to satisfy the second part of the all events test.

V. Conclusion

Accrual of estimated amounts to be paid for claims under state or federal workers' compensation laws for injuries occurring in the current taxable year should be deductible under several theories. The all events test is not an obstacle to accrual. The injury itself, if uncontested as to occurrence within the scope of employment, is an event which fixes a statutory obligation under the all events test. Since payments generally begin immediately, remoteness in time is not a problem. Where the taxpayer's accounting method results in an accrual accurately matching revenues and expenses, income clearly is reflected and tax accounting objectives are preseved. The conditions precedent versus conditions subsequent analysis also supports the proposition that injury fixes liability under no-fault statutes and that existing contingencies, bearing only on date and amount of payment, serve only to modify an already existing liability. Lastly, where a taxpayer has established that its accounting method and accrual clearly reflect income, it will have established that the means used in calculation are reasonable.

Taxpayers using an individual claim-by-claim analysis and administering their claims using an independent claims administrator to calculate the accrual have a strong case. The case may be strengthened if the claims administrator or taxpayer eliminates all contested claims from the accrual calculation. There does appear

239. 291 U.S. 193 (1934).

to be room, however, for a taxpayer to argue for inclusion of claims contested on the basis of *amount* but not *liability* or for a taxpayer to use an accrual estimation technique based on aggregate statistical data or group experience if the conditions of clear reflection of income can be independently satisfied.

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